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UNITED STATES TAX COURT

KENNETH M. HENSON AND SUE B. HENSON, Petitioners, v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 31654-83. Filed July 23, 1986.

Held: Disallowance of loss deduction and additions to tax for fraud sustained against Husband, a practicing lawyer, based upon falsely claiming a capital loss from a fictitious sale of stock. Other issues determined.

James C. Fleming and Bryan B. Lavine, for the petitioners.

Charles P. Honfman, for the respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined deficiencies and additions to tax for the years and the amounts indicated:

Years	Deficiency	Additions to Tax Section 6653(b)[1]
1974	$59,715.11	$29,857.55
1975	12,329.05	6,164.52
1976	28,755.03	14,377.51

After concessions, the principal issue in this case is whether petitioner Kenneth M. Henson (Henson) is liable for additions to tax under section 6653(b) for fraud.[2] The fraud additions are predicated upon respondent's contention that: for 1974 a sale of stock treated by Henson as a capital loss was a sham; for 1975 there was a failure to report for tax purposes a dividend in the amount of $2,356.56 from American Family Corporation (American Family); and for 1976 there was a failure to report a receipt of certain funds from Gasoil Products, Inc. (Gasoil) as taxable under the tax benefit rule. Also in issue are deficiencies in each year unless barred by the statute of limitations. Unless respondent's determination as to the fraud additions is sustained for the years 1974 and 1975, those years will be barred by the statute of limitations. With respect to 1976, respondent has an alternative contention with respect to the statute of limitations--that the year is open under section 6501(e).

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

[2] Respondent has stipulated that the fraud addition does not apply to Mrs. Henson whose interest in this matter is only by reason of having filed joint returns and a joint petition with this Court.

FINDINGS OF FACT

Some of the facts have been stipulated and they are so found. At the time the petition in this case was filed, petitioners were residents of Columbus, Georgia. Petitioners filed joint Federal income tax returns for each of the years 1973 through 1976, reporting their income and expenses on the cash method of accounting. Each of these tax returns was prepared by an independent accountant.

Henson is, and for many years has been, a lawyer engaged in private practice specializing in litigation with offices in Columbus, Georgia. Henson has some degree of familiarity with the law of Federal income taxation. During the period involved, he was aware of the distinction between ordinary income and capital gains and the basic elements of a wash sale under section 1091(a), including the 30-day period.

Gasoil Transaction

On October 30, 1973, petitioner made an investment in Gasoil pursuant to which he acquired a 5-percent interest in certain oil and gas leases in St. Mary's Parish, Louisiana.[3] Gasoil was obligated to drill a minimum of five wells, two wells to be drilled in 1973. The contract also provided reimbursement to Henson if less than five wells were drilled, the repayment or reimbursement being at the rate of $25,000 per failure to drill any of wells three, four, and five prior to the end of 1974. No provision was made for the drilling of only one well in 1973. Henson was also given the right to invest in subsequent wells. The purchase price for the oil and gas interest was $125,000. The amount of $25,000 was paid by check dated October 30, 1973. The $100,000 balance was represented by two notes, each dated October 23, 1973, one in the amount of $25,000 due on December 30, 1973, and one in the amount of $75,000 due January 19, 1974. The purchase agreements allocated to Hensen $75,000 in intangible drilling and development costs for the year 1973 and $50,000 for 1974. The $75,000 note gave Henson the right to cancel that note and his participation in the third, fourth, and fifth wells in the event that sale by Henson of his common stock in an unrelated corporation was not consummated. The $25,000 note was conditioned simply upon the performance by Gasoil of its agreements with Henson.

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[3] The investment is reflected in two documents. One document described as an "indenture" transfers a 5-percent interest in three oil and gas leases. This instrument is dated October 23, 1973, but is acknowledged on January 19, 1974. The second "agreement" dated October 23, 1973, recites that a 5-percent "working interest" had been acquired in five wells to be drilled. Various other rights, privileges, and obligations are created by (footnote continued)

During December 1973, petitioner wrote two checks to Gasoil each in the amount of $25,000. Each check was post-dated to December 31, 1973. One check recites that it was intended as

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(footnote continued from previous page)
this second instrument. Exact determination of the nature of the interest or interests acquired under the agreements is not important to our decision. Neither is the effective date important.

payment on the note due on December 30, 1973 and the other as part payment of the note due January 19, 1974. These two checks were mailed or otherwise delivered to a representative of Gasoil, Huel A. White, Jr. Neither check was deposited to the account of Gasoil in 1973. In the latter part of December 1973, Henson learned that only one well had been drilled which was a dry hole and that Gasoil was contemplating abandoning further drilling. Either in late December or in early January 1974 Henson requested that the checks be held by White undeposited until an amendment to the 1973 drilling agreement could be negotiated.

By an amending instrument dated January 19, 1974, Henson was relieved of liability for payment of the two 1973 promissory notes. Gasoil issued to Henson its own interest-bearing note in the sum of $50,000, secured by a mortgage and assignment of the oil and gas leases. The $50,000 note was payable on the earlier of 30 days after demand or 2 years from its date.[4] The two outstanding checks written by Henson in December 1973 were deposited by Gasoil on January 22, 1974. Although not entirely clear from the amended agreement, the sums represented by the two checks appear to have been loaned to Gasoil and are represented

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[4] There is nothing in the documents or the testimony explaining why the two December 1973 checks were treated as a loan. We infer, however, that the 1973 agreement was treated as creating an obligation in Gasoil to refund to Henson the sum of $25,000 for the failure to drill well two as well as $75,000, or any part thereof which Henson paid, for failure to drill wells three, four, and five. The basis for his claim on his 1973 income tax return of a $75,000 ordinary loss relating to his Gasoil investment is at best inconsistent with treating the two December 1973 checks as a loan to Gasoil. It is unfortunate that respondent failed to question this 1973 deduction.

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by Gasoil's note. At least the parties have so treated this 1974 transaction, and on that basis we so find.[5] Gasoil was relieved of further obligation to drill other wells, but if wells were drilled, Henson had an option to participate therein. Henson also had the right to direct investment of the $50,000 owed him by Gasoil in other wells or developments. By a separate instrument, he was given the right to market the St. Mary's Parish leases for a commission.

During 1974 petitioner received some interest payments from Gasoil on the $50,000 obligation, which were reported on petitioner's income tax return as such. In 1975 and 1976, Henson received interest payments from Gasoil (or from White on Gasoil's behalf) in the respective amounts of $4,169 and $932.08, but these amounts were not reported by Henson for Federal income tax purposes in his tax returns for those 2 years. Instead, he treated these sums as payments of principal. In addition, during 1976 Henson received the sum of $42,667 from Gasoil. Henson treated this amount as repayment to him of the $50,000 loan. This sum of $42,607 was received in two checks, one dated March 4, 1976 in the amount of $17,667 and the other dated January 22, 1976 in the amount of $25,000. The March check has endorsed upon it the legend "return of unused drilling funds Louisiana Prospects" and the January check "Return of drilling money." Both checks were endorsed to the order of Henson's law firm, the promissory note having been theretofore assigned to the law firm. The promissory note was marked paid and satisfied on March 11, 1976.[6] The $50,000 loan was a bona fide debt obligation of Gasoil to Henson made pursuant to the January 1974 amended agreement.[7]

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[5] It is unclear from the January 19, 1974, contract amendment whether the $50,000 is technically a loan or an advance by a principal to an agent.

American Family Stock Sale

American Family was organized in 1955 with Henson as one of the original subscribers. From time to time thereafter he purchased additional shares of stock. Some time prior to 1974 he became general counsel to the corporation. By December 11, 1974, Henson had accumulated at least 39,600 shares of American Family common stock.

Prior to 1974, Henson had become a stockholder in several small loan companies, including ALCO Finance, Inc. (ALCO). The president and chief executive officer of ALCO was Albert D. Long who owned 50 percent of the outstanding stock. The remaining stock was divided equally between Henson and George B. Smith. ALCO had been in business since 1968. During 1973 or early in 1974 there were discussions between Long, Henson, and others with respect to the desirability of expanding the business of ALCO through the acquisition of one or more other small loan companies. Such an acquisition would require the formation of a holding company, so that each small loan company could maintain an independent existence. It was recognized that Long, Henson, and Smith would have the same stock interest in such a holding company as they had in ALCO. Without direct authorization from Long, G. David Stapleton III (now deceased), a lawyer in Henson's law firm, prepared incorporation papers for a proposed holding company named Alco Industries, Inc. (Industries). Stapleton requested Long by telephone to visit his office to sign the incorporation papers, which Long did prior to June 7, 1974. During the telephone conversation or the office visit Long informed Stapleton or Henson, or both, that expansion of ALCO was not feasible at that time and Long had no need for and did not want the new corporation. Long was advised that Henson wanted or could use the corporation. Hence, Long was willing to sign the documents. Industries was actually incorporated on June 10, 1974.[8] The incorporation papers show the sole incorporator to be Long, its initial board of directors to be Henson, Long, and Stapleton, and the initial registered office to be the office of Henson's law firm.

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[6] It is unclear on this record whether Henson forgave the balance of the $50,000 note or whether he received some consideration in addition to the sum of $42,667. If interest payments received in 1975 and 1976 are applied against principal, Henson's principal balance was only $44,425.24 in January 1976.

[7] See n. 5, *supra*.

The minutes of the organizational meeting of the directors of Industries are dated June 15, 1974, and are signed by Long, Henson, and Stapleton. The minutes are, however, incomplete in that paragraph 3, which is intended to designate the individuals elected to the several offices of the corporation, omits the names of the officers. A plan to offer section 1244 stock, purporting to provide for 50 shares to be offered to Long and 25 shares each to Smith and Henson, is signed by Henson and Stapleton but not by Long. A certificate as to the corporate seal, signed by Stapleton, is dated June 15, 1974. The initial share subscription agreement is signed by Long, individually, and by him on behalf of Industries and recites that Long subscribed for 1,000 shares for the consideration of $1,000. An undated document signed by Long for the board of directors offers subscription rights to Messrs. Smith and Henson for 500 shares each. By document dated June 20, 1974, Henson and Stapleton resigned as officers and directors leaving Long as the sole member of the initial board of directors. Certificate Number 1 for 1,000 shares of Industry stock is dated June 15, 1974, and is signed by Long as president and Stapleton as secretary and shows Albert D. Long as the shareholder. The assignment printed on the back of this certificate is signed by Long in blank without a date inserted.[9]

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[8] Respondent contends, and petitioners do not deny, that Industries was incorporated on June 7, 1974, the date of an incorporation order of the Superior Court. However, the office of the Secretary of State certified that the incorporation was effective on June 10, 1974. This discrepancy is immaterial.

Next in point of time is a corporate document styled Meeting of Directors of Industries dated December 1, 1974 and signed by Long as president and director which recites that Industries was formed for the purpose of purchasing either Swift Loan and Finance Company or Swift Loan and Finance of Columbus, Inc. (referred to collectively as the Swift Loan Companies), that substantial corporate credit is needed to effect the purchase, and that Henson has expressed willingness to sell his shares of capital stock of American Family to Industries, which shares of stock would provide Industries with the needed credit. The record also includes a purported exchange of correspondence (discussed infra) between Henson and Long as president of Industries.

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[9] There are some other corporate papers included in the record but they are immaterial to these matters.

There is a letter dated December 11, 1974 to Long from Henson which purports to confirm the sale by Henson of 39,276 shares of American Family stock to Industries for a total purchase price of $157,104.[10] The consideration is an unsecured promissory note of the same date in that amount signed by Long as president of Industries. Henson's letter recites that the American Family stock may be used by Industries to collateralize any loan procured to facilitate the purchase of either of the Swift Loan Companies or the assets of either. Henson retained an option to repurchase the American Family stock after 30 days and up to 90 days from sale at the same price, provided an agreement for the acquisition of the assets or the stock of either of the Swift Loan Companies had not been made. Industries was also given the right to demand repurchase of the stock at the same price during that same period. The letter has endorsed on it an acknowledgment by Industries of the purchase, signed by Long on behalf of Industries.

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[10] Such a sale at that time would have generated a long-term capital loss to Henson of $177,351.48.

A second letter from Henson to Long as president of Industries, dated February 22, 1975, confirms a mutual agreement to repurchase the shares in view of the fact that Long has determined not to make any effort to purchase the stock or assets of either of the Swift Loan companies. This letter was also signed by Long as president of Industries. The note purportedly given by Industries to Henson dated December 11, 1974, to reflect the American Family stock purchase price has endorsed on it the words "Paid & surrendered 2/22/75 Kenneth M. Henson."

The two letters from Henson to Long, the Industries note, and the December 1, 1974 minutes of Industries' directors were drafted by Henson rather than by Stapleton and were typed by Henson's secretary on or about the dates of the documents. All of the corporate papers pertaining to Industries remained in Henson's law office files until some time during the year 1976.

In order to complete the purported sale of American Family stock to Industries, Henson personally delivered stock certificates for 39,600 shares to American Finance which reissued a new certificate for 39,276 shares in the name of ALCO Industries, Inc. This certificate is dated December 17, 1974 and was registered by Columbus Bank and Trust Company as registrar on December 18, 1974. The reissued certificate together with a certificate issued in Henson's name for 324 shares were delivered to Henson's office, on or shortly after December 18, 1974. A certificate for 39,276 shares retransferred to Henson was delivered to Henson shortly after May 12, 1975, which is the date on which it was processed for retransfer by American Family. American Family had no contact with Long or Industries except that, in March 1975, a dividend check in the amount of $2,356.56 was issued in the name of and mailed to Industries at the address of ALCO. At Henson's request this check was endorsed by Long and delivered to Henson.[11]

Long remembers signing Industries' documents at the request of Stapleton on only two occasions, once during 1974 and once during 1975. On each occasion, Long went to Stapleton's office and signed whatever documents Stapleton requested without paying attention to their contents. The first occasion obviously took place prior to the date of incorporation and must have occurred in May or early June 1974.[12] The occasion of Long's second visit to Stapleton must have taken place prior to May 12, 1975, since that was the approximate date of the retransfer of the American Family shares to Henson on the books of American Family. We cannot be certain on what date or dates the execution of the documents relative to the alleged sale of American Family shares to Industries and the alleged repurchase occurred. We can only find that the execution of those documents by Long did not take place in December 1974.[13] The sale and repurchase documents may have been executed by Long prior to June 10, 1974, some time in 1975 but prior to May 12, 1975, or in part on the earlier date and in part on the later date.

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[11] Henson denies receiving this dividend check.

[12] The timing of this execution by Long is based upon his testimony as well as the independent corroborating circumstantial evidence concerning the formalities of organization of the corporation.

[13] We rely upon Long's testimony for this conclusion and decline to accept Henson's testimony that these documents were signed by Long in December 1974.

The purported sale of American Family stock to Industries was not mentioned or discussed by anyone with Long, and Long was not aware that it had taken place, until March 1975 when he received the American Family dividend check payable to Industries. Long was not aware of the December correspondence from Henson or the purported plan to use Henson's American Family stock as collateral for loans to provide funds to purchase the stock or assets of either of the Swift Loan Companies until shown the documents by respondent's agents. Long never agreed with Henson that he (Long) would in any capacity attempt in December 1974 or early 1975 to purchase the assets or stock of either loan company. Long was not able to effect such a purchase in whole or in part for his own account and he did not participate in the organization of Industries in order to provide a vehicle for his efforts to effect such a purchase. No attempt was made by Long in December 1974 or in January or February 1975 to negotiate such a purchase with the owner of either loan company. Neither was any such attempt made by Henson. Long was not aware during 1974 or 1975 that on behalf of Industries he had signed either the December 11, 1974 or the February 22, 1975 letters and he did not affix his signature to the December 11, 1974 letter or the December Industries promissory note during December 1974.

The purported sale by Henson of the American Family shares to Industries did not, in fact, take place. It was structured by Henson so that at all times control of the American Family shares remained with him and he was assured the ability to repurchase the shares at the alleged sale price. Industries had no business or other reason to purchase the American Family shares and did not do so. The sole objective of the purported transaction was Henson's desire to realize a substantial tax loss to offset a capital gain in excess of $200,000 realized by him on a sale of some stock in an unrelated corporation which occurred on January 4, 1974. At the time Henson signed and filed or caused to be filed petitioners' 1974 Federal income tax return on which he claimed a long-term capital loss on the sale of 39,276 shares of American Family stock in the amount of $177,351.48, he knew that this sale had not taken place, that the documents purporting to reflect the sale were fictitious, and the sale transaction a sham.

Section 6501(e) Facts

During the examination of petitioners' tax liabilities, respondent's agents issued several summonses to third-party recordkeepers as defined in section 7609(a)(3). Petitioners stayed compliance of those summonses. A proceeding to enforce summonses issued to the Columbus Bank and Trust Company and other entities (Civil Nos. 78-160-COL, 78-161-COL, 78-162-COL, and 78-163-COL) was commenced in the United States District Court for the Middle District of Georgia, Columbus Division, on October 11, 1978, and the summonses were ordered enforced 60 days thereafter on December 11, 1978. A proceeding to enforce a summons issued to the National Bank and Trust Company (Civil No. 79-29-COL) was commenced in the United States District Court for the Middle District of Georgia, Columbus Division, on March 8, 1979, and was ordered dismissed 63 days thereafter on May 10, 1979.

By letters, each dated March 20, 1979, to Hon. W.A. Bootle, United States District Judge and to Mr. Howell Hollis, attorney for the National Bank & Trust Company, petitioners' attorney withdrew petitioners' objection to the enforcement of the summons issued to the National Bank & Trust Company. That bank responded to the summons by letter dated April 2, 1979.

OPINION

With respect to each of the years 1974, 1975, and 1976 the normal statute of limitations had expired prior to the issuance of the statutory notice. As to the years 1974 and 1975, the only basis for finding the statute of limitations to be inapplicable would be a finding of fraud on the part of Henson. For 1976, in addition to fraud, respondent contends that section 6501(e) is applicable. Our focus is thus initially on whether or not fraud has been proven.[14]

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[14] The statute of limitations is an affirmative defense, the burden of which is on the party raising it, that is, petitioners. There is, however, no dispute that the statutory notice was issued on August 10, 1983, almost 8 years after the filing of petitioners' 1974 tax return and slightly more than 7 years after the filing of the 1975 tax return. Therefore, the burden of going forward with the evidence would normally have shifted to (footnote continued)

Under section 6653(b) respondent has the burden of proof by clear and convincing evidence. Section 7454(a); Rule 142(b). To meet this burden, respondent must show that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968); Rowlee v. Commissioner, 80 T.C. 1111 (1983).

The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978); Estate of Pittard v. Commissioner, 69 T.C. 391 (1977). Fraud is not to be imputed or presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970); Otsuki v. Commissioner, 53 T.C. 96 (1969). However, fraud may be proven by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. The taxpayer's entire course of conduct may be examined to establish the requisite fraudulent intent. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, supra at 105-106 (1969). The intent to conceal or mislead may be inferred from the pattern of conduct. See Spies v. United States, 317 U.S. 492, 499 (1943). But fraud may not be found under "circumstances which at most create only suspicion." Davis v. Commissioner, 184 F.2d 86, 87 (10th Cir. 1950). Among the badges of fraud which may be taken into account

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respondent. However, in this case two of the years are open only if fraud is found and the burden of proof as to fraud is upon respondent.

are the making of false and inconsistent statements to revenue agents, Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980), and the filing of false documents, Stephenson v. Commissioner, 79 T.C. 995, 1007 (1982), affd. 748 F.2d 331 (6th Cir. 1984).

The basis for fraud in 1974 is the reported sale, at a significant loss, of the American Family stock. The idea for the sale originated with Henson though whether it originated prior to the organization of Industries or thereafter, we cannot determine. Since it is respondent's burden of proof, we will give Henson the benefit of the doubt and assume that the organization of Industries in June 1974 was motivated by Henson's hope of expanding the business of ALCO through the acquisition of the assets or stock of one of the two Swift Loan Companies which may have been available for sale. However, either he or Stapleton was told by Long, when Long was requested to sign the incorporation papers, that expansion of the ALCO business was not feasible at that time. If Henson did not participate in that conversation with Long, it is inconceivable that Stapleton did not so advise Henson. Thus, when Henson prepared the purported minutes of the directors' meeting of December 1, 1974, purporting to authorize the purchase of Henson's American Family shares of stock, and when Henson prepared the December 11, 1974, letter to Long, the promissory note of the same date, and the February 22, 1975, letter, he knew that Long was not interested in the proposal to expand ALCO's business by the acquisition of another loan company. Consequently, he knew ALCO had absolutely no reason to purchase Henson's American Family stock as collateral for prospective loans to finance such an expansion. Henson was sufficiently sophisticated in wash sales for Federal tax purposes to understand the mechanics which would be necessary to realize a loss on the American Family stock and he obviously was sufficiently astute to structure and paper a transaction to make it appear real. We simply give no credit to Henson's testimony under oath with respect to this purported sale.[15] Although Long's recollection of these matters was in some respects unclear, we believe that the facts he gave us were correct, especially his lack of knowledge of the purported sale of the American Family stock to Industries. If he had actually caused or concurred in the purchase of the American Family shares as Henson claims, Long would have certainly remembered that occurrence. We found no evidence of bias against Henson.

If either Long or Henson in the name of or on behalf of Industries had made any effort to negotiate for the acquisition of the assets or the stock of either of the Swift Loan Companies, corroborative evidence to that effect would have existed and been offered by petitioner. None was and we draw the appropriate negative inferences therefrom. Wichita Terminal Elevator Co. v.

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[15] A factfinder may choose to discount a party's self-interested testimony. Christensen v. Commissioner, 786 F.2d 1382 (9th Cir. 1986), affg. and remanding T.C. Memo. 1984-197. We so hold notwithstanding Henson's long membership in the bar of the State of Georgia and the reputation testimony by two friends as to his standing in the community. As the transcript shows, Henson's testimony is not convincing. We also observed him closely during the trial and found him lacking in candor. See, e.g., Anderson v. Commissioner, 250 F.2d 242 (5th Cir. 1957).

Commissioner, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947). This lack of evidence supports Long's testimony that his own personal financial situation and the general economic conditions in 1974 precluded expansion of the ALCO business. The transaction itself as outlined in the December 11, 1974 letter, even if it had taken place, lacks sufficient economic substance to be recognized for tax purposes unless and until the American Family stock had been pledged to secure a loan in order to acquire the assets or stock of a finance company. However, in this instance there was never any transaction intended; it was simply fabricated by Henson in order to permit Henson to claim a long-term capital loss on his Federal income tax return for the year 1974 which he in fact did. Henson thus filed his Federal income tax return claiming a capital loss deduction based on a fictitious transaction which he had created and well knew he was not entitled to claim.

Circumstantial evidence of Henson's fraudulent intent is shown by this record. When his 1974 income tax return was filed, Henson had been a practicing lawyer for approximately 28 years with a sufficient knowledge of tax law to understand the basic requirements of a wash sale. His structuring of a fictitious transaction to claim a loss of almost $178,000 makes fraud self-evident. We recognize that one portion of the purported sale of American Family stock was not fictitious. The stock was actually transferred on the books of American Family to Industries and a new certificate in the name of Industries issued and registered with the registrar. However, "taxation is not so much concerned with the refinements of title as it is with actual command over the property * * *." Corliss v. Bowers, 281 U.S. 376, 378 (1930); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Helvering v. Lazarus Co., 308 U.S 252 (1939); Miller v. Commissioner, 68 T.C. 767 (1977). The transferred certificate never left Henson's possession. The fact that American Family may have treated the transfer as valid is immaterial. By reason of his position as general counsel for American Family, Henson was assured of being able to have the transaction effected and recorded on the American Family books while retaining full control over the shares of stock. This tag end part of the purported transaction cannot validate the remainder and does not prevent us from treating it for what it was, a mere sham.

By reason of our finding fraud, the statute of limitations has not run for the year 1974. Respondent's determination disallowing the loss on the purported sale of this stock and the addition to tax for fraud under section 6653(b) are sustained for 1974.

In 1975, the deficiency is relatively small consisting of several items of omitted income including the American Family dividend. While the American Family stock transaction was in effect completed in 1975 with the retransfer of the stock to Henson, that transaction was not reflected on Henson's 1975 income tax return and cannot be considered as tainting his return for that year. Respondent argues that Henson could not report the American Family dividend because such action would cast doubt upon the validity of the sale. If this were correct, it would buttress respondent's position but we find the argument unpersuasive under the facts here. Respondent's argument is not sufficient to carry his burden of proving fraud by clear and convincing evidence. The omissions from income in 1975 standing alone are insufficient in this case to sustain fraud. We conclude that the year 1975 is barred by the running of the statute of limitations.

The transaction in 1976 which allegedly supports the fraud addition is the failure to report the receipt of $42,667 from Gasoil. Respondent contends that this 1976 payment is related to the $75,000 deduction for intangible drilling and development costs taken in 1973 and under the tax benefit rule constitutes ordinary income in 1976. While we tend to believe that the Gasoil transaction whereby petitioner purchased interests in oil and gas leases and wells was incorrectly reported by Henson for Federal income tax purposes with respect to the year 1973, that year is not before us and an error in claiming a deduction in 1973 albeit between the same parties, cannot color an alleged omission of income from a different transaction in 1976. We have found, and respondent does not contend to the contrary, that the conversion in January 1974 of the two $25,000 tentative payments by Henson on his 1973 loans into a loan by Henson to Gasoil was a legitimate transaction, creating an indebtedness of Gasoil to Henson. The $42,667 payments in 1976 on that promissory note were just that. Whether the tax benefit rule serves to convert that receipt of funds into income is a complex Federal income tax question, as our discussion of that issue below indicates. Henson's obligation to report this sum as income was not so clear at the time his 1976 income tax return was filed as to sustain the fraud addition to tax. Respondent has not carried his burden of proof on this issue. Thus, the year 1976 is closed unless open by reason of section 6501(e).

For the 6-year statute of limitations to apply pursuant to section 6501(e), the statutory notice must obviously be issued within 6 years from the date the return was filed. However, the running of the statute of limitations may be suspended pursuant to section 7609(e). Insofar as pertinent, this section provides that if a taxpayer whose liability is involved intervenes in a summons enforcement proceeding, "the running of any period of limitations under section 6501 * * * shall be suspended for the period during which a proceeding, and appeals therein, with respect to the enforcement of such summons is pending." Both parties agree that this section of the Code is applicable. The disagreement is with respect to its interpretation. Technically, the enforcement proceeding with respect to the summons issued to the National Bank & Trust Company was pending from March 8, 1979 to May 10, 1979, a period of 63 days. Petitioners argue, however, that both the District Court and the bank were notified within approximately 25 days after March 8, 1979, that petitioners' objection was withdrawn and the bank actually complied with the summons a few days thereafter. If petitioners' argument is sound, the statute of limitations was not suspended under section 7609 for a sufficient period of time to permit the statutory notice to have been issued within the proper period. On the other hand, if respondent's interpretation is correct, than the running of the 6-year statute of limitations was suspended for a sufficient period of time to permit the statutory notice to have been timely.

Respondent relies on section 301.7609-5(b), Proced. & Admin. Regs. This provision of the regulations is quoted in full in the margin.[16] The summons enforcement proceeding with respect to the National Bank & Trust Company was clearly pending between March 8, 1979 and May 10, 1979. Under the regulation, the fact of compliance has "no effect on the suspension provisions."

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[16] Sec. 301.7609-5. Suspension of statutes of limitations.

(b) Period during which a proceeding, etc., is pending. Under section 7609(e), the statute of limitations may be suspended for the period during which a proceeding, and appeals therein, with respect to the enforcement of such summons is pending. This period begins on the date the action to enforce the summons is commenced, rather than the date a notified person takes any action as provided in section 7609(b). An action to enforce the summons is commenced upon the filing of the petition or complaint to enforce the summons. The period continues until all appeals are disposed of, or until the expiration of the period in which an appeal may be taken or a request for a rehearing may be made. Full compliance, partial compliance, and noncompliance have no effect on the suspension provisions. Of course, if the notified person takes no action provided in subsection (b) of section 7609, no suspension of the statutes of limitations takes place. The periods of limitations which are suspended under section 7609(e) are those which apply to the taxable periods to which the summons relates.

The regulation is effective with respect to summonses issued after February 28, 1977.

Petitioners argue that application of this regulation is unfair or inequitable, but it is an appropriate interpretation of the statute. Certainly we cannot say that the regulation is "plainly inconsistent" with the statute. See Bingler v. Johnson, 394 U.S. 741 (1965). We agree with respondent that the statutory notice for the year 1976 was issued within the 6-year period, as extended during the summons enforcement proceedings.

The second requirement for section 6501(e) is that the taxpayer must have omitted from gross income "an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return." In order to meet the 25-percent test, respondent must include the sum of $42,667 received by Henson in 1976 in gross income. Unless this amount is properly includable in income, the 25-percent test will not be met. As the basis for the inclusion, respondent has cited Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), and Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 89, 90 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972). Respondent's theory is that the payment to Henson with respect to the $50,000 note is so related to the 1973 deduction by Henson of $75,000 on account of the Gasoil investment in the dry hole that the tax benefit rule causes what otherwise is simply repayment of a loan to be taxable income. We simply do not agree.

The most recent and authoritative formulation of the rule is of course from the Supreme Court's opinion in Hillsboro.

> The Government in each case relies solely on the tax benefit rule--a judicially developed principle that allays some of the inflexibilities of the annual

> account system. An annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals. [Citation omitted.] Nevertheless, strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper. * * * [460 U.S. at 377.]
>
> * * *
>
> The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax, * * * and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule. We do not, however, agree that this consequence invariably follows. Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction. * * * A court must consider the facts and circumstances of each case in the light of the purpose and function of the provisions granting the deductions. [460 U.S. at 383-385.]
>
> When the later event takes place in the context of a nonrecognition provision of the Code, there will be an inherent tension between the tax benefit rule and the nonrecognition provision. [Citations omitted.] We cannot resolve that tension with a blanket rule that the tax benefit rule will always prevail. Instead, we must focus on the particular provisions of the Code at issue in any case. [460 U.S. at 385-386.]
>
> [Fn. ref. omitted.]

Petitioners' deduction claimed on their 1973 income tax return was presumably claimed under section 263(c), although the return does not so indicate. The deduction is claimed on Form 4797--Supplemental Schedule of Gains and Losses in part 2 under the heading "Ordinary Gains and Losses" with the description "Investment in Gasoil Products, Inc. J.M. Burguieres Co. Limited, Well Number 1." Petitioners on brief all but concede that the 1973 deduction was improper or at least excessive but this does not help respondent.

The only event which would be "fundamentally inconsistent" with the 1973 deduction of $75,000 was the amendment to the agreement in January 1974, which among other things converted the two $25,000 checks from payments on the 1973 notes into a loan to Gasoil. Repayment of that loan in 1976 had nothing whatsoever to do with the 1973 deduction. If all three events had occurred in the same year, it is not the loan repayment which would be inconsistent with the $75,000 deduction; rather it is the canceling of Henson's obligations and switching of payments into a loan to Gasoil.[17] The repayment of the loan to Gasoil in 1976 is simply too remotely associated with the 1973 deduction to warrant application of the tax benefit rule.

Respondent also argues on the strength of Mayfair Minerals v. Commissioner, supra, that the tax benefit rule applies even though the 1973 deduction was erroneous. Our opinion in Mayfair Minerals does not help respondent either. The 1976 treatment of the sum of $42,667 was not inconsistent with the 1973 deduction; rather it was entirely consistent with the 1974 amended agreement. As a consequence, the 25-percent test of section 6501(e) is not met. The other items of omitted income, assuming that the American Family dividends were taxable in full,[18] are not sufficient to meet the 25-percent requirement. Accordingly, the statute of limitations for the year 1976 had run prior to the issuance of the statutory notice.

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[17] Respondent has not argued before us that some amount, such as $50,000, should have been taxable in 1974 under the tax benefit rule. It would be inappropriate for us to raise that issue on our own motion and it is now too late for respondent to change his theory.

Decision will be entered
under Rule 155.

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[18] It is possible that the American Family dividends were not taxable in full, a determination yet to be made by respondent.

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T. C. Memo. 1986-304

UNITED STATES TAX COURT

RAYMOND E. AND DEBORAH L. GRACE, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17365-84. Filed July 23, 1986.

Larry Kars, for the petitioners.

Terence D. Woolston, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: Respondent determined deficiencies in petitioners' joint Federal income taxes as follows:

Year	Deficiency
1977	$ 668.00
1978	1,193.00
1980	2,699.00

After concessions, the issues for decision are: (1) whether petitioners are entitled to claim an investment credit pursuant to section 38[1] for 1980 and investment credit carrybacks for 1977 and 1978 relating to petitioner husband's[2] investment in JAM Productions, a partnership, and, (2) whether petitioners are entitled to deduct losses for 1980 relating to petitioner's investment in JAM Productions.[3]

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in Scottsdale, Arizona, when they filed their petition in this case.

Petitioner was employed by Gerald Kramer, Ltd. as a certified public accountant during 1980. Petitioner was supervised by Gerald Kramer and Edwin W. Balder. ("Edwin Sr.")

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[1] Unless otherwise specified, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

[2] Deborah L. Grace was not involved in any of the transactions at issue except by virtue of her community property interest, if any. Therefore, unless otherwise specified, petitioner shall refer only to Raymond E. Grace.

[3] Petitioners have conceded their liability for self-employment taxes for 1980 under sec. 1401. Rule 34(b)(4). Petitioners' medical expense deduction for 1980 under sec. 213 will be determined arithmetically in accordance with our determination as to the deductibility of losses attributable to petitioner's investment in JAM Productions.

In the course of his employment, petitioner prepared tax returns. As a certified public accountant, petitioner was aware of different types of business operations and knew of risks associated with a general partnership.

In 1980 petitioner invested in JAM Productions ("JAM") which purportedly leased a master recording from UM Leasing Corp. ("UM"). UM was a corporation formed on June 10, 1980, by Stephen Hill. William Medina ("Medina") was the president of UM and a director.

In 1980 UM acquired 82 master recordings from Banyan Productions, Inc. ("Banyan") owned by Jack Millman ("Millman").[4] The master recordings were subsequently leased to third parties including JAM. The purchase price for each master recording was paid by a small cash downpayment and a note in an amount generally equal to 98 or 99 percent of the stated purchase price. The notes were recourse. Banyan held approximately $100,000,000 in notes, secured by the master recordings, from UM attributable to the master recordings sold. However, Banyan did not investigate the financial condition of UM and had no reasonable expectation of repayment. UM was required to apply for registration of a claim of copyright with respect to the master recording. The purchase agreements purportedly gave UM the exclusive right to the master recordings.

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[4] Millman consented to an entry of Final Judgment of Permanent Injunction under sec. 7408 relating to the organization and sale of interests in another tax shelter.

Banyan acquired the master recording subsequently leased to JAM from Al M. Biaggi. The cost of the master recording was $2,500 in cash. The rights given to Banyan were nonexclusive.

With the master recording Banyan was to provide a title opinion prepared by Thomisina Reed, an attorney, and two appraisals of the master recording. UM accepted master recordings without title opinions. The appraisals for the master recording subsequently leased by JAM were prepared by Robert Scherl and Sye Mitchell.

By the spring of 1981 the title to some of the master recordings had been challenged and in 1983 UM instituted suit against Banyan and Millman. In addition to problems with the title to some of the master recordings, UM was notified by lessees prior to the end of 1980 that the technical quality of some of the master recordings was not adequate. A UM employee listened to cassettes of the master recordings on receipt from Banyan and could have rejected any of inadequate technical quality.

Master recordings are not normally sold in the music industry unless the seller is in bankruptcy or terminating its music business. When such a sale does occur, the buyer would check the registration certificate at the U.S. Copyright Office, if any, the artist's contract, the licenses for the writers and other materials which would indicate that the seller possessed the rights purportedly being sold. Normally, the seller would be known in the industry.

In December of 1980 petitioner attended a seminar relating to leasing master recordings through UM. The seminar was conducted by Edwin Sr. for Monetary Planning & Management ("MPM") of which he was president and sole owner. Edwin Sr. had discussed this program with petitioner outside of the seminar. Also present at the seminar were Medina and Peter Bennett, special consultant to UM.

MPM received a commission on the first two lease payments made by any UM lessee. MPM received in excess of $100,000 in commissions related to the 1980 UM leasing program. In 1980 MPM also handled a program for Beaux Arts Editions, Ltd., Inc., an affiliated corporation of UM dealing in lithograph sales. On March 2, 1981, MPM was designated as the national marketing organization for UM and Beaux Arts Editions, Ltd., Inc.

At the seminar participants were given a packet of materials relating to the lease program through UM. These materials included a brief synopsis of the program and a description of the tax benefits which could be derived from participation. Five categories of master recordings were listed as available for lease. The categories were determined on the basis of the "cost" of the lease of the master recording ranging from $230,000 to $1,500,000. Also included was an illustration of the tax consequences of participation. One illustration showed "Total Potential Federal Tax Savings 1980" of $26,289 or $28,423 on an investment of $12,500, and an explanation of the requirement of "Profit Motive" for Federal income tax purposes. The materials explained that the expectation of profit need not be reasonable. No information was provided as to the profit potential for participation. Other materials enclosed in the packet were information on how to establish and operate a business and copies of various Federal and state tax forms which should be filed, including a Form 1045, Application for Tentative Refund, and a Form 1139, Corporation Application for Tentative Refund. A copy of a legal opinion letter drafted by "Bishop & Hill" was also enclosed. The opinion letter assumed that each lessee had the requisite "profit-making" intent. Finally, enclosed was a copy of a letter dated November 6, 1980, promising that UM would defend one case should the Internal Revenue Service challenge the projected tax benefits.

Mack Gilchrist ("Gilchrist"), who later became associated with petitioner, also attended the seminar. A tax projection was prepared for Gilchrist showing that participation in the UM program would result in "Net Dollar Savings" of $21,700. Gilchrist was a high school teacher. Gilchrist was not familiar with the master recording business and did nothing to investigate the business other than talking to Edwin Sr., Edwin H. Balder ("Edwin Jr.") and J. Rance Smith ("Smith").

Smith had recommended the UM leasing program to Gilchrist. Smith was employed as an insurance salesman and had been previously employed as a teacher and coach. Gilchrist did not believe that Smith had any experience in the music or entertainment industry. In fact Smith's experience was limited to "plays and dramatic acts, and working with kids, as a school teacher," singing around a campfire and producing "a lot of fight songs for the team." Smith had learned about the UM leasing program through Edwin Sr. Subsequently, he read materials relating to the program provided by UM and MPM and discussed the program with Jim Smith, an attorney, Terrell Rogers, a certified public accountant, and members of the firm of Gerald Kramer, Ltd. Smith received a finder's fee from MPM for referring Gilchrist and others to the UM leasing program.

A document nominated as a "General Partnership Agreement" and dated December 17, 1980, was executed by Gilchrist for JAM. The agreement showed that Gilchrist had an 80 percent ownership interest in JAM and had made a contribution of $14,800. No other partners signed this agreement nor were any other ownership interests or contributions reflected. However, a second, substantially identical agreement was executed by Gilchrist, Nancy L. McBride and Edwin Sr., the latter two as partners of Dos Amici, a partnership. The second agreement showed that Gilchrist, Dos Amici and petitioner had ownership interests of 80 percent, 10 percent and 10 percent, respectively, and had made contributions of $14,800, $1,850 and $1,850, respectively. The principal place of business of JAM was listed as "1622 East de Caballos, Tempe, AZ 85284" on both agreements, and the purpose of the partnership was listed as leasing, manufacturing, producing and distributing master recordings in both agreements. The partnership address was Gilchrist's home address.

Petitioner did not know Gilchrist at the time JAM was formed. Edwin Sr. had arranged for petitioner's acquisition of an interest in JAM. Petitioner did not do any independent investigation but relied on Edwin Sr. and the information supplied at the seminar when investing in JAM.

Gilchrist executed an "Agreement of Lease" of a master recording on behalf of JAM effective December 17, 1980. The agreement provided that the property leased was "described in Schedule 1 attached hereto." However, on December 17, 1980, no master recording had been selected for lease although it was clear that the master recording selected would be one from those available in the $430,000 cost category. The term of the lease was 85 months from the date of delivery of the master recording.

The rental payments due from JAM were $18,400 for the first 12 months of the lease, payable at the inception of the lease, and $4,600 for the thirteenth through the fifteenth months payable at the end of the eighth month of the lease term. From the sixteenth month through the expiration of the lease term, rent of $1,533.33 plus any arrearages was payable at the end of the month. The rental payments were limited to 70 percent of net receipts for the month. Net receipts were defined as gross receipts less returns, allowances and artist's royalties. Artist's royalties were listed as ".02 cents per cut." Statutory, mechanical royalties payable for rerecording the music were listed as ".02 3/4 per selection." In addition to these payments the lessee was required to make payments equal to 20 percent of net receipts up to $25,000 per month for exploitation of the master recording.

On default of any required payments, the lessor's only remedy was repossession of the master recording. The lease also provided that the lessor would execute a consent to pass the investment tax credit through to the lessee. Further, the lease provided that the lessee would apply for registration of a claim of copyright with respect to the master recording. Finally, the lease provided that the master recording could be substituted if there were a material defect in it. The lease did not purport to give the lessee exclusive rights to manufacture, produce or distribute the selections on the master recording.

Gilchrist submitted payment to UM in the amount of $14,800 on December 17, 1980. On December 30, 1980, petitioner submitted payment to UM in the amount of $1,850. By check dated January 2, 1981, petitioner received $555 from MPM. This amount represented the commissions paid to MPM by UM on petitioner's investment. Dos Amici also submitted a lease payment to UM in the amount of $1,850. Edwin Sr. received a commission on this lease payment.

Before choosing a master recording Gilchrist and Edwin Sr. consulted with Edwin Jr. Edwin Jr. recommended Joni Mitchell as a popular artist who consistently had album sales in excess of 300,000 copies. Petitioner, Gilchrist and Edwin Sr. also read music industry publications which confirmed that Joni Mitchell was a popular recording artist. A Joni Mitchell master recording "Conversations" was selected.

None of the JAM partners listened to the Joni Mitchell master recording prior to selection. UM did send the master recording to Edwin Sr. after selection, and he and Gilchrist listened to the recording on January 26, 1981. Gilchrist accepted the master recording for JAM. Neither Gilchrist or Edwin Sr. believed the master recording to be of poor technical quality although Edwin Sr. was aware of surface sound noises.

By agreement dated March 5, 1981, JAM entered into an employment contract with United Distribution, Ltd. ("UDL") for production, distribution and promotion of records and tapes of the Joni Mitchell master recording. The agreement was nonexclusive and was to commence on March 5, 1981, and terminate on June 30, 1984, or earlier on ten days written notice. On execution of the agreement UDL received $3,500 to produce 750 to 1,000 test records. UDL suggested other distributors for national distribution. UDL was authorized to distribute up to 500 promotional copies. UDL was to pay JAM 80 percent of the sales price less production costs for records or tapes sold and not returned within 30 days. UDL was to account to JAM biannually. The agreement also provided that UDL was to pay expenses as directed by JAM. The agreement was signed on behalf of JAM by Gilchrist.

UDL was established in 1980 and owned by Edwin Jr. Edwin Jr.'s experience in the music industry was limited to working as a musician and as a salesman in a stereo or record store. Leon Ross ("Ross") was employed by UDL. Ross had no prior experience in the record distribution industry. Petitioner and Gilchrist did not adequately investigate the extent of Edwin Jr.'s and Ross's experience in the music industry.

The decision to employ UDL was made by petitioner and Gilchrist. Edwin Sr., Edwin Jr.'s father, did not participate in the decision because of potential conflict. Edwin Jr. was a salesman for the UM leasing program.

There was negligible partnership business activity in 1980 and 1981. The partnership reported no income for either of these years. Gilchrist, who had assumed responsibility for any business activities of the partnership, established and maintained a checking account in the name of the partnership, signed any documents necessary for the partnership, kept partnership records and ordered stationery and business cards for JAM. These activities, were in part, suggested at a seminar conducted by Edwin Sr. in 1981. UDL did not produce any records from the master recording during 1981 although it did create a production album cover, contact a record producer and have a stamper manufactured from which records could be produced. In addition UDL contacted local businesses on behalf of JAM and other UM lessees to arrange for distribution of records in generic covers.

On November 12, 1981, Gilchrist notified UDL that the distribution agreement was to be terminated within 10 days and requested the return of any materials in the custody of UDL. JAM did not locate another distributor until July of 1982 when Edwin Sr. contacted Ross, formerly of UDL, who was conducting business through Heritage Sound Recording Distributors ("Heritage"). Edwin Sr. scheduled an appointment with Ross and informed the other partners of JAM of this appointment stating that "such meeting would be most important and beneficial to business and tax structures." A meeting was held on July 29, 1982. As a result of the meeting, Gilchrist signed a contract with Heritage dated August 14, 1982, on behalf of JAM which provided for the pressing of 100 records at a cost of $476.00. In the contract JAM warranted that it had the exclusive right to manufacture and distribute the record and its contents. On November 17, 1982, Heritage made a presentation for the partners of JAM and other UM leasing program investors in which a group advertising campaign was outlined. This meeting was summarized in a memorandum from Edwin Sr. which concluded "REMEMBER! THE I.R.S. IS WATCHING!!" JAM paid a rateable portion of the cost of a newspaper advertisement, and the advertisement was run in December of 1982. No other newspaper advertising was done for JAM.

Heritage produced a total of 109 records for sale by JAM. These record albums were offered for sale in a blank jacket with a label affixed to the record listing song titles. An album in a

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blank jacket could not be sold in the normal retail market. Moreover, because of the poor quality of the records produced, they were unacceptable as commercial recordings. The label which was affixed to the record incorrectly listed the selections on the record. Of the total records produced for sale, nine were sold and seven albums were given to radio stations and newspapers for promotion. Approximately ten additional test albums were distributed to the media.

On July 28, 1983, the Federal Bureau of Investigation contacted Ross and issued a verbal cease and desist order to him relating to the manufacture and sale of the JAM album "Conversations." The cease and desist order was based on a complaint by Siquomb Publishing Corporation, the owner of the musical composition rights. Both before and after the cease and desist order Ross had attempted to get information from UM to permit copyright of the record and mechanical licensing. This information was never produced, and Heritage ceased production and distribution activities after July 28, 1983. From that date to the date of trial, no further production or distribution activities were attempted with respect to the "Conversations" master recording.

Neither Banyan nor UM had any contractual right to Joni Mitchell's performance.[5] Joni Mitchell was under exclusive contract with Warner Bros./Seven Arts, Records, Inc., Asylum Records, Elektra/Asylum Records and The David Geffen Company from December 1, 1967, through the date of trial. Although a waiver of the exclusive right to Joni Mitchell's services could have been granted, no waiver was granted by the companies to whom she was under contract.

Information relating to the ownership of the rights to Joni Mitchell's performance and the rights to the use of the musical compositions on "Conversations" was readily available to the public.[6] A publication, "Phonologue", available in retail music stores provides a cross index of information relating to artists, record companies, songs and album names. The Recording Industry Association of America, a trade association, also provides information to the public. Other sources of information would be the U.S. Copyright Office and one of the organizations which protect music songwriters and publishers. Information would also be available by visiting a local record store and locating albums currently available by the artist. Joni Mitchell's album "Ladies of the Canyon" which contains all of the selections available on "Conversations" was still being sold in retail stores in 1983.

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[5] Petitioners argue that under the Uniform Commercial Code a buyer may acquire greater rights than the seller had. While this statement is generally true, application to copyrighted material would abrogate the purpose of copyright protection. 1 Nimmer, Nimmer on Copyright, sec. 1.03[A] (1985).

[6] In fact, Robert Scherl, one of Banyan's appraisers, was requested to research the ownership of rights to certain recordings. As to the Joni Mitchell master recording sold by Banyan as "Conversations" he concluded:

> This album originally released as "Ladies of the Canyon" * * * . This the exact configuration of original issue. Mitchell has always been a WBA artist, first on Reprise, now on Asylum. No evidence of WBA ever licensing any of her product elsewhere.

Petitioners' counsel objected to the introduction of this document on the basis that the document was undated and that the author of the document was not available at the trial of the case. We will sustain counsel's objection to the extent that we will not consider the document to prove the truth of the matters therein nor to prove that the information contained therein was

(footnote continued)

By August of 1983 the Internal Revenue Service had contacted lessees of the UM leasing program and requested that they complete a questionnaire relating to their investments. Edwin Sr. through MPM advised lessees, including the JAM partners, on the proper procedure for dealing with the Internal Revenue Service. On August 20, 1983, Edwin Sr. conducted a seminar in which he reviewed the materials presented to those individuals who invested in the UM leasing program. In addition he reviewed responses which could be used to answer the Internal Revenue Service questionnaire.

(footnote continued from previous page)
available to Banyan, UM or any of the leasing program investors during 1980. However, we will consider this document to the extent that it indicates that information relating to ownership of the right to Joni Mitchell's performance could be obtained through investigation.

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A notice of deficiency was issued to petitioners on March 19, 1984. In the notice of deficiency respondent made the following explanation of items for 1977.

> We have disallowed the investment credit you claimed because you did not establish that you are entitled to this credit.

Shown on return as previously adjusted	$668.00
Corrected Amount	$ 0.00

> Because this credit was fully disallowed in the year of investment, your carryback to this tax year has been fully disallowed.

There was a similar explanation for 1978, varying only as to the amount shown on the return. In 1980 the following explanation of items was made:

> It is determined that the ($1,850.00) and $__ claimed on your returns filed for the years 1980 and _____ respectively, as being your distributive share of a partnership loss incurred by "JAM Productions" are not allowable because it has not been established that you owned any interest nor had any basis in this alleged partnership, nor that the alleged partnership, if formed, engaged in any business or profit motive transactions during the years at issue. It has likewise not been established that, if the alleged partnership was formed and engaged in any business or profit motive transactions, said partnership incurred any expenses or losses during the years at issue. Accordingly, your taxable income is increased $1,850.00 and $ _____ for the 1980 and _____ years, respectively.
>
> It is determined that the $4,300 claimed on your return filed for the year 1980 as being your distributive share of the investment credit from "JAM Productions" is not allowable because it has not been established that you owned any interest nor had any basis in the alleged partnership, nor that the alleged partnership, if formed, engaged in any business or profit motive transactions during the year at issue. It has likewise not been established that, if the alleged partnership was formed and engaged in any business or profit motive transactions, said partnership acquired any "Section 38 property", as defined in Internal Revenue Code

> of 1954, Section 48 during the year at issue. Accordingly, your income tax is increased $2,439 for the 1980 taxable year.

Petitioners did not receive the page explaining the adjustment relating to partnership losses of JAM. However, the complete notice of deficiency was served on petitioners with respondent's answer on August 8, 1984. In their petition petitioners claimed that respondent's determinations were in error and asserted, in part, that the value of the master recording was at least $430,000. Respondent denied this assertion in his answer.

OPINION

The sole issues before the Court are whether petitioners are entitled to an allocable share of partnership loss and investment credit attributable to JAM. The partnership loss is the result of rental deductions claimed by JAM in the amount of $18,500 and the investment credit is the result of a pass through of benefits attributable to the purported lease of a master recording by JAM. Respondent denied the loss and investment credit on a variety of grounds.[7] We find that JAM did not engage in any activity with the objective of making a profit and decline to consider respondent's other arguments.

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[7] In the notice of deficiency respondent stated, in part, that the absence of "any business or profit motive transaction" precluded the loss and credit claimed by petitioners as a result of petitioner's investment in JAM. In his brief respondent claimed that the partnership transactions were a sham. The record does not disclose that petitioners were informed of this theory until respondent submitted his pre-trial memorandum shortly before the trial of this case. Petitioners assert that they were surprised and prejudiced by respondent's belated (footnote continued)

In order to claim the rental expense and investment credit JAM must satisfy the requirements of section 162(a) or 212(1) or (2) and section 38, respectively. These provisions require that

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(footnote continued from previous page) assertion that the transactions were a sham.

We have declined to consider a theory or issue raised by respondent when the Court determines there has been surprise and substantial disadvantage to petitioners in the presentation of their case because of the manner in which the notice of deficiency and pleadings were drawn compared to the issues raised at trial. Estate of Horvath v. Commissioner, 59 T.C. 551, 555 (1973). The Court will find surprise and substantial disadvantage where the evidence required to be presented on the issue or theory not pled is different than the evidence which would be presented in support of the issues or theories pled. Estate of Horvath v. Commissioner, supra at 556.

As articulated in a recent opinion of the Court of Appeals for the Fourth Circuit, there is a two pronged test for determining whether a transaction is a sham. Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985), affd. on this issue 81 T.C. 184 (1983). The first prong of this test is subjective and requires a determination of whether the taxpayer had a business purpose for entering into the transaction. Rice's Toyota World, Inc. v. Commissioner, supra at 92. The second prong of the test is objective and requires a determination of whether there was a reasonable possibility of economic profit apart from the tax benefits. Rice's Toyota World, Inc. v. Commissioner, supra at 94. The consequences of a finding of sham is that the transaction will be recharacterized according to its substance. Rice's Toyota World, Inc. v. Commissioner, supra at 95.

Here, the notice of deficiency only encompassed the subjective aspect of the lease transaction. It did not encompass the objective aspect of the lease transaction. Therefore, although the notice of deficiency is sufficient to notify petitioners that respondent would base his denial of loss and investment credit on failure to satisfy the profit objective requirement under secs. 162(a) or 212(1) or (2) and 38, it is not sufficient to notify petitioners that respondent would raise the theory that the transaction was a sham. While the elements of

(footnote continued)

the activity be engaged in with an actual and honest objective of making a profit. Capek v. Commissioner, 86 T.C. 14, 36 (1986); Flowers v. Commissioner, 80 T.C. 914, 931 (1983). A reasonable expectation of profit is not required, but the taxpayer's profit objective must be bona fide. Surloff v. Commissioner, 81 T.C.

(footnote continued from previous page)
proof relating to both theories may be identical, in substantial part, we believe that the focus of counsel's preparation may have been differenct had the sham theory been raised earlier. Under the facts of this case we cannot determine or say that respondent's belated claim of sham did not result in surprise or disadvantage to petitioners. Consequently, in the absence of any evidence that petitioners were informed of the sham transaction theory prior to the date respondent submitted his pre-trial memorandum, we conclude that the sham theory was not timely raised. We note that we reach this result "in an abundance of caution" and, on the basis of this record, would have sustained respondent's argument that the transactions were a sham if that issue was properly before us. In this respect it is significant that Sye Mitchell, one of the appraisers employed by Banyan, appeared at the trial of this case and claimed his Fifth Amendment privilege to each question posited except his current occupation and home address in December of 1980. Respondent did properly raise the issue of profit objective, and our determination in this case is based on that theory.

Petitioners also claim that respondent did not properly raise issues or theories with respect to whether JAM had valid title to the master recording, the fair market value of the master recording, whether JAM leased sec. 38 property and the date the master recording was placed in service. We find that each of these factors could be elements of proof of the issues clearly stated in the notice of deficiency and will not decline consideration of these factors within the context of our analysis of JAM's profit objective. In addition we note that the fair market value of the master recording was delineated as an issue through the pleadings.

Finally, in the alternative, petitioners seek to raise an issue as to a theft loss resulting from the transactions. If such a loss occurred it seems that it would be in a year not before this Court. We have no jurisdiction to make such a redetermination. Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418 (1943). In addition petitioners did not timely raise this issue. We will not permit petitioners to raise new
(footnote continued)

210, 233 (1983); Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. without published opinion sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984). "Profit" means economic profit without consideration of tax savings. Capek v. Commissioner, supra at 36; Surloff v. Commissioner, supra at 233. If the activity is not engaged in with the requisite objective of making a profit, the deductions are only allowable to the extent that gross income derived from the activity exceeds deductions allowable irrespective of whether the activity is engaged in for profit. Sec. 183(b)(2).

Where the activities are conducted by a partnership, the profit objective must be present at the partnership level. Fox v. Commissioner, supra at 1006; Brannen v. Commissioner, 78 T.C. 471, 505 (1982), affd. 722 F.2d 695 (11th Cir. 1984). However, since a partnership is merely a formal entity, a determination of profit objective can be made by reference to the activities of the individuals who manage the partnership. Rosenfeld v. Commissioner, 82 T.C. 105, 112-113 (1984); Fox v. Commissioner, supra at 1007-1008. These individuals need not be partners.

(footnote continued from previous page)
issues while strenuously arguing that respondent should not be permitted to raise new issues. "What is sauce for the goose is sauce for the gander."

Fox v. Commissioner, supra at 1008. When the partnership is passive in its operations, the prudence it exercises in acquiring property and assigning duties to third parties and the care with which it oversees the performance of such duties are of heightened importance. Flowers v. Commissioner, supra at 932.

The issue of whether the partnership has the requisite profit objective is one of fact which is to be resolved by examination of the surrounding facts and circumstances. Capek v. Commissioner, supra at 37; Hager v. Commissioner, 76 T.C. 759, 784 (1981). In making this determination, the Court will give greater weight to objective facts than mere statements of intent. Surloff v. Commissioner, supra at 233. The burden of proof is on petitioners to show the existence of a profit objective. Rule 142 (a).

Here, Gilchrist was purportedly the managing partner of JAM. However, Gilchrist and the other partners relied on the advice of Smith, Edwin Sr., Edwin Jr. and Ross. As these parties were active in the management of JAM, their actions are significant in making a determination as to whether there was the requisite profit objective at the partnership level.

Initially, we note that Smith, Edwin Sr. and Edwin Jr. all benefitted from the lease of the master recording from UM irrespective of the success of the venture. All three received finder's fees or commissions on the initial lease payments made by participants in the program. In fact MPM, of which Edwin Sr. was the sole owner, received in excess of $100,000 from the 1980

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UM leasing program. MPM also marketed programs for an affiliate of UM and became the national marketing organization for UM and the affiliate. Edwin Jr. received $3,500 from JAM.

None of the parties involved in the management of JAM had a significant degree of experience in the music industry. Gilchrist conceded that he had no knowledge of the music industry. Smith, his business advisor, was similarly lacking in expertise. There is no evidence in the record that Edwin Sr. had any experience in the music industry. Edwin Jr., who was purportedly knowledgeable in the music industry, had been a musician and a salesman in a stereo or record store. Ross's first experience in the record distribution industry was at the time of his employment by UDL. Petitioner and the other partners made no attempt to investigate the qualifications of these advisors and, in some cases, were aware that these advisors had no expertise in the music industry. Despite his lack of expertise Gilchrist was authorized to listen to and accept the master recording on behalf of the partnership. At the time the master recording was leased none of the partners of JAM or their advisors attempted to ascertain whether UM, their lessor, had the rights which were subject to the lease. This information could have been ascertained by visiting a local record store. "Ladies of the Canyon" which contains all of the selections listed on "Conversations", the master recording leased by JAM, was available in retail record stores. In addition "Phonologue" which provides a cross index of information relating to artists, record companies, songs and album names could have been consulted. Certainly the lease provision requiring the lessee to apply for registration of a claim of copyright with respect to the master recording should have alerted the partners of JAM and their advisors that further investigation should be conducted before entering into the lease agreement with respect to a designated master recording. In fact, the JAM partners appeared to be oblivious even to the rights purportedly transferred to them under the lease agreement with UM. Although the lease agreement was nonexclusive, JAM warranted to Heritage that it had exclusive rights.

The record clearly indicates that tax benefits as opposed to economic profit were the inducement for investment in the UM leasing program. The materials distributed at the seminar presented by MPM in December of 1980 indicated only that investors in the UM leasing program could enjoy significant tax savings in excess of the amount of cash actually invested by utilizing the investment credit provisions. No information was provided as to anticipated economic profit from investment in the program. The materials did explain that an investor need not have a reasonable expectation of profit, suggesting that investors could ignore the economic aspects of their investment.

Edwin Sr. assisted investors, including the JAM partners, in establishing and maintaining a business facade which he hoped would avoid Internal Revenue Service scrutiny. Edwin Sr. conducted seminars to explain what procedures should be followed to create the appearance of an operating business. When the UDL agreement was terminated, JAM did not enter into another distribution or production agreement for approximately nine months. Edwin Sr. urged that an agreement be executed to protect the tax structure. After an agreement had been reached with Heritage, Edwin Sr. suggested that UM leasing program investors participate in a group advertising campaign cautioning "REMEMBER! THE I.R.S. IS WATCHING!!"

On this record the only conclusion which we can make is that JAM leased a master recording solely for the purpose of providing tax benefits to its partners and commission income and finders' fees to Edwin Sr., Edwin Jr. and Smith. The transactions were highly unusual in the music industry, and JAM through its partners and advisors failed to take any action which would ensure that the venture was a success. JAM, acting through its partners and advisors had no objective for profit, reasonable or otherwise. Consequently, the deductions claimed under sections 162(a) or 212(1) or (2) and the investment credit under section 38 were properly disallowed by respondent. JAM had no income from the activity in 1980 and cannot utilize section 183.

Finally, we wish to caution petitioners and others who are involved in similar tax avoidance or evasion schemes that the Court is authorized to award damages to the United States in an amount up to $5,000 when a proceeding is instituted or maintained primarily for delay or where petitioners' position therein is frivolous or groundless. Sec. 6673. In Elliott v. Commissioner, 84 T.C. 227, 248 (1985), affd. 782 F.2d 1027 (3d Cir. 1985), we warned that "[a]t some point arguments in these highly leveraged tax avoidance (or evasion) schemes must be regarded as 'frivolous or groundless,' [under] section 6673". We reiterate that language here and note that damages were considered in Brown v. Commissioner, 85 T.C. 968 (1985), and awarded in Oneal v. Commissioner, 84 T.C. 1235 (1985). We will not hesitate to award damages in appropriate circumstances.

To reflect the foregoing,

Decision will be entered
for the respondent.

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T. C. Memo. 1986-305

UNITED STATES TAX COURT

JOHN A. and MARJORIE E. HARMON, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27143-84. Filed July 23, 1986.

Jeffrey Dickstein (at trial only) and William Van Doren (post-trial only), for the petitioners.

Michael R. McMahon, for the respondent.

G. M.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined deficiencies of $19,483 and $30,116 in petitioners' Federal income taxes for 1979 and 1982, respectively. By Amendment to the Answer, respondent alleged additional amounts to be due under sections 6659, 6653(a), 6621, and 6661.[1] At issue is petitioners' entitlement to deductions and investment tax credit in relation to lease of a children's record, lease of a video game, and a ceramics and quilting activity.

FINDINGS OF FACT

Petitioners were residents of Alaska at the time they filed their petition herein. They filed joint individual income tax returns for 1979 and 1982 with the Internal Revenue Service Center at Ogden, Utah.

On December 30, 1982, petitioners entered into an equipment lease with Cambridge Systems Leasing Corporation (Cambridge) for the lease of a 45 rpm master children's recording entitled "Talking Books for Children: Tale of Benjamin Bunny" (Benjamin Bunny). Benjamin Bunny is the creation of Beatrix Potter, the well known author of Peter Rabbit. The lease provided in part:

> 2. **Term:** The term of the lease shall commence on the date hereof and shall be for a period of ninety-six

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

> months (eight years), provided, however, that Lessor shall have the right to terminate the term of this lease by notice in writing to Lessee to such effect, given within thirty (30) days after the expiration of sixty-one (61) months of the term hereof, if Lessee has not within said sixty-one month period paid to lessor any additional rental pursuant to paragraph 3A hereof.
>
> 3. **Rental:** The prepaid rental shall be paid on execution hereof and allocated as follows:

CIRCLE:	A	B	C	D
Advance Rental:	$5,000.00	$7,500.00	$10,000.00	$2,500.00
Allocation:				
1st Year 65%	$3,250.00	$4,925.00	$ 6,500.00	$1,625.00
Years 2-8-5%	250.00	375.00	500.00	125.00

> 3A. **Additional Rental:** Lessee shall remit to Lessor as additional rental hereunder, twenty-five (25) percent of all "gross revenues" earned by the Master during the term hereof and received by any distributor of copies of the Master, prior to any deduction for cost of pressing, distribution, and promotion, or otherwise (i.e., such "gross revenues" shall equal all sales receipts by a distributor (whether or not such distributor is the Lessee) at wholesale prices, of records produced from the Master). All such additional rental payments shall be made to Lessor within thirty (30) days after the distributor(s) employed by Lessee (or Lessee himself if Lessee is the distributor) receives and computes such "gross revenues". Lessee shall compute, or shall cause each distributor of copies reproduced from the Master hereunder to compute "gross revenues" received with respect to the Master not less frequently than on six (6) month intervals during each calendar year of the term hereof, and shall pay or cause each distributor to pay the additional rental due to Lessee [sic] as required hereunder. At Lessor's request, Lessee shall conduct such reasonable examination of any distributor's books and records as may be reasonably necessary to verify the accuracy of computations and payments made with respect to the Master by such distributor.

Petitioners paid $5,000 to Cambridge on December 30, 1982, which, under the terms of the agreement with Cambridge, was allocated

$3,250 rental attributable to the first year of the lease and the balance of $1,750 attributable to years 2 through 8 of the lease at $250 per year. The lease agreement provided for additional rental of 25 percent of gross revenues earned by Benjamin Bunny.

Also on December 30, 1982, petitioners entered into an employment agreement with Aim Record Distribution, Inc. (Aim Record) for distribution of Benjamin Bunny. The agreement provided in part:

> 3. **Term.** Distributor's employment commences as of the date hereof and shall continue thereafter for thirteen months, unless terminated at any time prior thereto by the Owner on sixty days prior written notice; provided, however, that in the event of such termination, Distributor shall have the right to sell off any inventory of Recordings on hand as of the date of receipt of such notice.
>
> 4. **Delivery Requirements.** At all times during the term, the Master Recording shall remain the property of the Owner. The Owner, however, shall make available to Distributor, on request, the Master Recording, photographs, biographical material relating to any artist and the individual producers, label data, parts, copyright information, and such other material, as may relate thereto. Distributor acknowledges that all such items shall be delivered to the Distributor subject to the rights of Owner's lessor of the Master Recording.
>
> 5. **Manufacture, Release, Distribution and Sale of the Recordings.**
>
> a) Distributor accepts employment hereunder and shall, on behalf of the Owner and solely upon the prior written authorization of the Owner, cause Recordings to be manufactured from time to time so as to enable their contemplated commercial exploitation. Such manufacture, subject to such prior written authorization, shall be at the Owner's sole cost, expense and liability.

Supplementing the foregoing, upon execution hereof the Owner will make an advance payment of $2,500 for 33-1/3 r.p.m. long-play recording or equivalent cassette; or $1,500 for 45 r.p.m. single, to Distributor, to cover all of the costs of manufacturing and distributing (other than Distributor's Fee as hereinafter provided) of the Initial Run of Recordings within the United States. Such manufacture shall begin and be completed as and when required by the demand for the Recordings. In the event the Recordings are 45 r.p.m. Recordings such manufacture shall not exceed 1,050 copies. In the event the Recordings are 33-1/3 long play Recordings or equivalent cassette such manufacture shall not exceed 1,050 copies. Distributor shall not be required to account to the Owner for the application of such advance payment.

b) Distributor shall cause the release of the Recordings in the United States not later than one hundred twenty days from the date of delivery of all the items included in Paragraph "4" hereof, provided that Owner shall have complied with the delivery requirements set forth in Paragraph "4" hereof and the Owner shall have made the payment called for in paragraph "5.a)" hereof.

c) Subject to the foregoing, Distributor shall have the sole right to determine and control the manner of release, sale, distribution, sub-distribution and other exploitation with respect to the Recordings, such right to include, without limitation, the following rights:

(i) to determine the wholesale and retail selling price of the Recordings;

(ii) to distribute the Recordings on a free or no-charge basis to disc jockeys, distributors, dealers and others for promotional purposes or otherwise in connection with their sale, regardless of whether such free or no-charge records are meant for resale to the ultimate consumer and to sell Recordings as cut-outs or for scrap at a salvage or close-out price; provided, however, that no such cut-out or scrap sales shall be effected during the first three months of the term without the Owner's prior written consent, unless the Owner shall have cancelled this Agreement, as herein provided for, in which case Distributor shall have all such rights effective as of the date of receipt of such cancellation;

(iii) to discontinue the manufacture of the Recordings;

(iv) to make, alter and cancel contracts involving the manufacture, advertising, promotion and sale of the Recordings and to make allowances and give credits to its sub-distributors or other contracting parties;

(v) to adjust and settle all disputes with its sub-distributors or other contracting parties.

* * *

7. **Fee for Services.** In addition to the advance payment paid pursuant to Paragraph "5," herein and otherwise in full consideration of the services to be performed hereunder, Distributor shall be entitled to retain fees for Recordings sold by it as follows:

a) From Gross Receipts Distributor shall retain ten (10%) percent thereof as a distribution fee for services hereunder.

b) From the balance of Gross Receipts remaining, Distributor shall retain the costs of:

(i) manufacturing and packaging of Recordings;

(ii) AFM, AFTRA and copyright royalties assessed on the sale of the Recordings manufactured, sold and not returned;

(iii) costs of promotion, sales and advertising of Recordings;

(iv) costs of freight and shipment of Recordings; and

(v) all artists and producers royalties and payments to any musician or performer on the Master Recording due on account of sales of Recordings as required.

c) The balance of all Gross Receipts shall be paid to the Owner as hereinafter provided for in Paragraph "8."

Petitioners paid $1,500 to Aim Record on December 29, 1982.

Also on December 30, 1982, petitioners entered into an equipment lease with Century Concepts, Inc. (Century) for the lease of a master video game entitled "Pulsator." The lease provided in part:

> 2. **Term.** The term of the lease shall commence on the date hereof and shall be for a period of ninety-six months (eight years), provided, however, that Lessor shall have the right to terminate the term of this lease by notice in writing to Lessee to such effect, given within thirty (30) days after the expiration of sixty-one (61) months of the term hereof, if Lessee has not within said sixty-one month period paid to lessor any additional rental pursuant to paragraph 3A hereof.
>
> 3. **Rental.** The prepaid rental shall be paid on execution hereof and allocated as follows:
>
> Advance Rental: $15,000.00
>
> Allocation:
> 1st Year 65% $9,750.00
> Years 2-8-5% 750.00
>
> 3A. **Additional Rental:** Lessee shall remit to Lessor as additional rental hereunder, twenty-five (25) percent of all "gross revenues" earned by the Master during the term hereof and received by any distributor of copies of the Master, prior to any deduction for cost of reproduction, distribution, and promotion or otherwise (i.e., such "gross revenues" shall equal all sales receipts by a distributor (whether or not such distributor is the Lessee) at wholesale prices, or cassettes produced from the Master). All such additional rental payments shall be made to Lessor within thirty (30) days after the distributor(s) employed by Lessee (or Lessee himself if Lessee is the distributor) receives and computes such "gross revenues". Lessee shall compute, or shall cause each distributor of copies reproduced from the Master hereunder to compute "gross revenues" received with respect to the Master not less frequently than on six (6) months intervals during each calendar year of the term hereof, and shall pay or cause each distributor to pay the additional rental due to Lessee [sic] as

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> required hereunder. At Lessor's request, Lessee shall conduct such reasonable examination of any distributor's books and records as may be reasonably necessary to verify the accuracy of computations and payments made with respect to the Master by such distributor.

Petitioners paid $15,000 to Century on December 30, 1982, which was attributed $9,750 to the first year of the lease and $5,250 to years 2 through 8 of the lease at $750 per year. The lease also provided for an additional rental of 25 percent of all gross revenues earned by Pulsator.

Also on December 30, 1982, petitioners entered into an employment agreement with Aim Software Distribution, Inc. (Aim Software) providing for distribution of Pulsator. The agreement provided in part:

> 3. **Term.** Distributor's employment commences as of the date hereof and shall continue thereafter for thirteen months, unless terminated at any time prior thereto by the Owner on sixty days prior written notice; provided, however, that, in the event of such termination, Distributor shall have the right to sell off any inventory of Programs on hand as of the date of receipt of such notice.
>
> 4. **Delivery Requirements.** At all times during the term, the Master Program shall remain the property of the Owner. The Owner, however, shall make available to Distributor, on request, the Master Program, photographs, biographical material relating to any programmer and/or the individual producers, label data, parts, copyright information, and such other material, as may relate thereto. Distributor acknowledges that all such items shall be delivered to the Distributor subject to the rights of Owner's lessor of the Master Program.

5. Manufacture, Release, Distribution and Sale of the Programs.

a) Distributor accepts employment hereunder and shall, on behalf of the Owner and solely upon the prior written authorization of the Owner, cause the Program to be manufactured from time to time so as to enable its contemplated commercial exploitation. Such manufacture, subject to such prior written authorization, shall be at the Owner's sole cost, expense and liability.

Supplementing the foregoing, upon execution hereof the Owner will make an advance payment of Thirty-Eight Hundred ($3,800) Dollars to Distributor to cover all of the costs of manufacturing and distributing (other than Distributor's Fee as hereinafter provided) of the Initial Run of the Program within the United States. Such manufacture shall begin and be completed as and when required by the demand for the Program. Such manufacture shall not exceed five hundred and eleven (511) copies. Distributor shall not be required to account to Owner for the application of such advance payment.

b) Distributor shall cause the release of the Program in the United States not later than one hundred twenty days from the date of delivery of all the items included in Paragraph "4" hereof, provided the Owner shall have complied with the delivery requirements set forth in Paragraph "4" hereof and the Owner shall have made the payment called for in Paragraph "5.a)" hereof.

c) Subject to the foregoing, Distributor shall have the sole right to determine and control the manner of release, sale, distribution, sub-distribution and other exploitation with respect to the Program, such right to include, without limitation, the following rights:

(i) to determine the wholesale and retail selling price of the Program;

(ii) to distribute the Program on a free or no-charge basis to distributors, dealers and others for promotional purposes or otherwise in connection with its sale regardless of whether such free or no-charge programs are meant for resale to the ultimate consumer, and to sell the Program as cut-outs or for scrap at a salvage or close-out price; provided, however, that no such cut-out or scrap sales shall be effected during the first three months of the term without the Owner's prior written consent, unless the Owner shall have cancelled this Agreement, as herein provided for, in which case Distributor shall have all such rights effective as of the date of such cancellation;

(iii) to discontinue the manufacture of the Program;

(iv) to make, alter and cancel contracts involving the manufacture, advertising, promotion and sale of the Program and to make allowances and give credits to its sub-distributors or other contracting parties;

(v) to adjust and settle all disputes with its sub-distributors or other contracting parties.

* * *

7. **Fee for Services.** In addition to the advance payment paid pursuant to Paragraph "5," herein and otherwise in full consideration of the services to be performed hereunder, Distributor shall be entitled to retain fees for Programs sold by it as follows:

a) From Gross Receipts Distributor shall retain ten (10%) percent thereof as a distribution fee for services hereunder.

b) From the balance of Gross Receipts remaining, Distributor shall retain the costs of:

(i) manufacturing and packaging of the Program;

(ii) copyright royalties assessed on the sale of the Programs manufactured, sold and not returned;

(iii) costs of promotion, sales and advertising of the Programs;

(iv) costs of freight and shipment of the Programs; and

(v) any and all programmer and producer royalties and/or payments on the Master Program due on account of sales of the Program as required.

> c) The balance of all Gross Receipts shall be paid to the Owner as hereinafter provided for in Paragraph "8."

Petitioners paid $3,800 to Aim Software on December 29, 1982.

During 1982, petitioners had items of gross income, other than from the activities here in issue, totaling $91,013. Petitioners consulted with Elmer Pratt (Pratt) concerning preparation of their tax return for 1982. Pratt advised petitioners to invest in Cambridge and Century programs. Pratt personally invested in other programs promoted by Cambridge and Century, after meeting with various individuals involved with the Cambridge and Century investment programs. Neither petitioners nor Pratt had any experience with marketing or distributing children's records or video games. According to Pratt, he "wanted to be certain that the tax aspects were right."

Each of the Cambridge and Century programs was marketed as a "tax advantaged equipment lease," and promotional brochures relating to them emphasized representations that:

> Equipment leasing allows individuals to garner large Investment Tax Credits.
>
> * * *
>
> I.T.C. is a dollar-for-dollar swap with tax liability.

In smaller print, each brochure stated that:

> [Cambridge or Century] as purchaser and lessor of each Master, is fully "at risk" for the value of the Master

> and will sign a full-recourse promissory note to that effect with each purchase. The I.T.C. is an elective passthrough mutually agreed to by the lessor and lessee. It is definitely advisable for the lessee to go into the business of exploiting the Master. However, the choice of distributor as well as the methods utilized to market the Master are solely at the discretion of the lessee.

Cambridge represented that each master 45 rpm associated with a lease payment of $5,000 would have a "master value" of $125,000 and result in an investment tax credit of $12,500. Century represented that each video game master associated with a lease payment of $15,000 would have a "master value" of $375,000 and result in an investment tax credit of $37,500. Petitioners did not engage in any negotiation of the terms of either lease entered into by them. Petitioners did not hear or see either Benjamin Bunny or Pulsator until on or after April 27, 1983. They secured no appraisals of either Benjamin Bunny or Pulsator before investing in the programs.

On or after March 14, 1983, petitioners received from Cambridge two appraisals of Benjamin Bunny. On or after May 12, 1983, petitioners received from Century two appraisals of Pulsator. None of the appraisals set forth a fair market value in terms of the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. All of the appraisals were based solely on projections of a stream of income to be received in the future assuming sales at particular prices and volume levels provided by Cambridge or Century. The appraisers assumed sales of 588,000 to 690,000 copies of Benjamin Bunny and 92,500 units of Pulsator over periods of 14 and 6 years, respectively. (The leases were for 8 years.) At no time did petitioners receive any data supporting the alleged appraisals other than representations of the sellers of Benjamin Bunny and Pulsator.

Petitioners made no attempt to market Benjamin Bunny or Pulsator other than through Aim Record and Aim Software, which had not agreed to manufacture more than 1,050 copies of Benjamin Bunny or 511 copies of Pulsator, respectively. Until a dispute arose over their tax treatment of the investments on their 1982 tax returns, petitioners did not make any further inquiries of Cambridge, Century, Aim Record, or Aim Software and incurred no expenses relating to Benjamin Bunny or Pulsator beyond the payments made in December 1982. Petitioners received a statement from Aim Record dated March 31, 1984, reporting that there were no gross receipts from the sales of Benjamin Bunny in 1982 and 1983. On December 11, 1984, Aim Record sent petitioners a "final accounting" reporting that gross receipts from the sale of Benjamin Bunny in 1984 were $1.65. On March 31, 1984, Aim Software reported that there were no gross receipts from the sales of Pulsator in 1982 or 1983. On October 12, 1984, Aim Software rendered a "final accounting" that gross receipts in 1984 were $110.40.

During 1982, petitioner Marjorie E. Harmon made quilts and ceramic figures. Although this activity started out as a hobby, Mrs. Harmon sold some of her creations. She charged customers what she believed to be the approximate costs of manufacture of the items. She received $1,282 from sales of those items in 1982.

During 1982, petitioners engaged in some preliminary investigation of the possibility of a gun business. They did not, however, commence a gun business in 1982.

Petitioners' income tax return for 1982 was signed on January 26, 1983. On that return, petitioners claimed to have invested in "qualified investment property" in the amount of $500,405, of which $125,000 was attributable to Benjamin Bunny and $375,000 was attributable to Pulsator. Petitioners claimed investment tax credit of $50,041, and applied $19,388 to their reported 1982 income tax liability. They claimed and received a refund of taxes withheld from Mr. Harmon's wages in 1982. Petitioners elected to carryback $19,483 of the reported investment tax credit from 1982 to 1979, and they claimed and received a refund of that amount.

On a Schedule C attached to their 1982 income tax return, petitioners reported a business activity of "marketing-sales & service." They reported gross receipts of $1,282 and costs of goods sold of $960. They claimed advertising expenses of $5,300, consisting of $1,500 paid to Aim Record and $3,800 paid to Aim Software, and a deduction for rent of $13,000, consisting of

$3,250 paid to Cambridge and $9,750 paid to Century. In addition, they claimed the following expenses:

Car and truck expense	$ 402
Depreciation	1,636
Dues and publication	74
Insurance	198
Legal and professional services	100
Repairs	112
Supples	287
Taxes	55

In a statutory notice of deficiency dated April 26, 1984, respondent disallowed the investment tax credit and all of the expenses claimed by petitioners other than $24 for costs of goods sold; $48 car and truck expense; and $157 depreciation.

Lessors' elections to pass investment credits to petitioners as lessees were executed by Cambridge on or about May 17, 1983 and by Century on or about May 16, 1983. Petitioners consented to the elections on or about May 10, 1983.

The principal purpose of the investment plans or arrangements made by petitioners with Cambridge and Century was the avoidance or evasion of Federal income tax.

There was a substantial understatement of income tax on petitioners' return for 1982 attributable to petitioners' investment plans or arrangements with Cambridge and Century.

OPINION

Procedural Matters

Prior to trial, petitioners' sought continuance of this case "until the case against Cambridge Corp., Aim Distributors, and Century Concepts has been decided." No case involving the tax liability of the promoting entities, however, was found to be pending in this Court. Issues involved in determining the tax liabilities of Century, Cambridge, or the distributors would not be identical to or even correlative to issues in this case.[2]

Petitioners also objected to being required to proceed with this case while other taxpayers, perhaps represented by counsel, who invested in the Century and Cambridge programs had not proceeded to trial. Although consolidation, selection of "test" cases, or other grouping of cases may be invoked by the Court where efficient use of time and money may be accomplished, petitioners are not entitled to delay trial of their own case. Petitioners secured refunds in excess of $50,000 based on the investment tax credits claimed by them and supported by a representation that they were in a trade or business. They cannot now be allowed to postpone indefinitely the determination of their entitlement to those credits because they lack knowledge about their purported trade or business.[3]

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[2] The parties stipulated to various documents concerning Cambridge and Century, including tax returns of those entities. They have been disregarded in our findings because they are unreliable hearsay as to the issues in this case. In relation to the Court's denial of petitioners' motions for continuance, however, it is relevant that on July 5, 1984, a judgment was entered against Cambridge and Century, among others, on their consent, enjoining them under sections 7402 and 7408 from the organization or sale of abusive tax shelter programs, including, but not limited to, master recordings and master video games. There is no indication that a continuance for a reasonable time would increase the likelihood that petitioners would secure helpful evidence with the assistance of Cambridge or Century.

The Nature of Petitioners' Activities

To qualify for the investment tax credit or for the losses claimed on Schedule C of their 1982 return, petitioners must establish that their activities with respect to Benjamin Bunny, Pulsator, or ceramics and quilting either constituted trades or businesses or were undertaken and carried on for the production of income. See Flowers v. Commissioner, 80 T.C. 914, 931 (1983); Pike v. Commissioner, 78 T.C. 822, 841-842 (1982), affd. without published opinion 732 F.2d 164 (9th Cir. 1984).

Essential to such a showing is a demonstration that petitioners had "an actual and honest objective of making a profit." Dreicer v. Commissioner, 78 T.C. 642, 646 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); Fuchs v. Commissioner, 83 T.C. 79, 98 (1984); Dean v. Commissioner, 83 T.C. 56, 74 (1984). While a reasonable expectation of profit is not required, petitioners' objective of making a profit must be bona fide. Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd.

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[3] In addition, the Court holds session in Anchorage, Alaska, where petitioners requested that trial be held, only once a year. A short continuance, therefore, was not feasible.

without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Zemel v. Commissioner*, 734 F.2d 9 (3d Cir. 1984), affd. without published opinion sub nom. *Rosenblatt v. Commissioner*, 734 F.2d 7 (3d Cir. 1984), affd. without published opinion sub nom. *Krasta v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Leffel v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner*, 734 F.2d 5 (3d Cir. 1984). "The courts have used words such as 'basic,' 'dominant,' 'primary,' 'predominant,' and 'substantial' to describe the requisite profit motive." *Lemmen v. Commissioner*, 77 T.C. 1326, 1340 (1981). See also *Herrick v. Commissioner*, 85 T.C. 237, 254 (1985); *Flowers v. Commissioner*, 80 T.C. at 931. "Profit" in this context means economic profit, independent of tax savings. *Herrick v. Commissioner*, *supra*; *Surloff v. Commissioner*, 81 T.C. 210, 233 (1983).

Whether petitioners possessed the requisite profit objective is a question of fact to be resolved on the basis of all the facts and circumstances.[4] *Elliott v. Commissioner*, 84 T.C. 227,

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[4] Sec. 1.183-2(b), Income Tax Regs., lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed in the regulation are as follows:

> (1) *Manner in which the taxpayer carries on the activity*. * * *

(footnote continued)

236 (1985), affd. without published opinion 782 F.2d 1027 (3d Cir. 1986), and cases cited therein. Although no one factor is determinative, greater weight must be given to objective facts than to petitioners' mere statement of their intent. Siegel v. Commissioner, 78 T.C. 659, 699 (1982); Engdahl v. Commissioner, 72 T.C. 659, 666 (1979); sec. 1.183-2, Income Tax Regs. Moreover, as discussed in greater detail below, the absence of a particular indicia of profit motive may be more significant to our determination than the superficial presence of another indicia. Respondent's determination is presumptively correct, and petitioners bear the burden of proving petitioners' profit objective. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

Based on the facts set forth above, we conclude that petitioners did not engage in the lease of Benjamin Bunny or Pulsator with an actual and honest objective of making a profit but instead engaged in the transaction primarily, if not

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(footnote continued from previous page)

(2) The expertise of the taxpayer or his advisors. * * *
(3) The time and effort expended by the taxpayer in carrying on the activity. * * *
(4) Expectation that assets used in activity may appreciate in value. * * *
(5) The success of the taxpayer in carrying on other similar or dissimilar activities. * * *
(6) The taxpayer's history of income or losses with respect to the activity. * * *
(7) The amount of occasional profits, if any, which are earned. * * *
(8) The financial status of the taxpayer. * * *
(9) Elements of personal pleasure or recreation. * * *

exclusively, to obtain tax deductions and credits and thereby reduce the tax they would otherwise have to pay on their income from other sources. Moreover, we have found that the principal purpose of these activities was the avoidance or evasion of Federal income tax. Petitioners are therefore not entitled to the claimed deductions or investment tax credit.

Petitioners contend that in 1982 they were seeking investments that would produce income for their retirement. They assert that they invested in Benjamin Bunny and Pulsator in reliance on Pratt and on the materials received from Cambridge and Century. It is apparent, however, that Pratt, Cambridge, and Century were recommending the investments based on the anticipated tax benefits, which, in summary, would supposedly secure for petitioners over $50,000 in immediate tax refunds in exchange for payments totaling $25,300. Petitioners had no obligation beyond the initial payment in the absence of actual sales of the product, and they had no obligation to and in fact did not attempt to effect sales of the product. The purported fair market values of the items were based on assumed sales of at least 588,000 copies of Benjamin Bunny and 92,500 units of Pulsator, but petitioners never arranged for manufacture of more than 1,050 copies of Benjamin Bunny or 511 units of Pulsator. These programs were patently too good to be true. Petitioners made no effort to follow up on their dealings with Cambridge and Aim Record or Century and Aim Software until investigation of their tax liabilities commenced.

The facts speak for themselves. It would give undue dignity to petitioners' claims to belabor them or to repeat here what this Court and others have had to say about comparable situations in which we have repudiated "the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along." Saviano v. Commissioner, 765 F.2d 643, 654 (7th Cir. 1985), affg. 80 T.C. 955 (1983).

> The long and short of it all is that the parties demeaned themselves in entering so dishonest a venture, unquestionably structured to garner for each of the taxpayers tax advantages to which they were not entitled and devoid of any realistic business purpose. * * * [Barnard v. Commissioner, 731 F.2d at 232.]

See also Elliott v. Commissioner, 84 T.C. at 247-248.

With respect to the ceramics and quilting activity, petitioner Marjorie Harmon's description of the manner in which she made incidental sales to friends or acquaintances at her estimated cost of those sales establishes that she did not have an actual and honest profit objective with respect to these activities. Because she had gross income from that activity, however, she is entitled to deductions to the extent of gross income for ordinary and necessary expenses incurred during 1982. Section 183(b)(2). Petitioners have not, however, produced any testimony or documentary evidence to satisfy their burden of proving that they actually incurred any deductible expenses in relation to this activity beyond the amounts allowed by respondent. Thus no additional deductions can be allowed.

Investment Tax Credits

Section 48(d)(1) provides as follows:

> (1) General Rule.--A person (other than a person referred to in section 46(e)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to any new section 38 property * * * to treat the lessee as having acquired such property for an amount equal to--
>
> (A) except as provided in subparagraph (B), the fair market value of such property, or
>
> (B) if the property is leased by a corporation which is a component member of a controlled group (within the meaning of section 46(a)(6)) to another corporation which is a component member of the same controlled group, the basis of such property to the lessor.

Sections 1.48-4(f) and (g), Income Tax Regs., set forth the manner in which the lessor may make the election referred to in section 48(d). The election is made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, *on or before the due date* (including any extensions of time) of the lessee's return for the taxable year. Petitioners' return was filed in January 1983, no doubt because they were expecting large refunds. The return otherwise was not due until April 15, 1983. The elections by the lessors, however, were not signed until May 1983. They were, therefore, technically invalid; and the requirements for the lessees to receive credit under section 48(d) were not met.

In addition, section 48(d) assumes eligibility for credit under sections 38 and 46, which in turn require that property be placed in service during the taxable year. Section 46(c). Petitioners have not shown that either Benjamin Bunny or Pulsator was even in existence prior to 1983.

Finally, section 48(d)(1), supra, limits the amount eligible for the investment tax credit to the fair market value of the property acquired by the lessee. Thus, in order to establish their entitlement to investment tax credit, petitioners had the burden of proving the fair market value of Benjamin Bunny and of Pulsator. They offered no evidence on this issue. The appraisals provided to them by Cambridge and Century were admitted only to show that petitioners had received them, which was relevant to whether or not they had an actual and honest profit objective, as discussed above, and whether or not they were negligent, as discussed below. Those appraisals in any event did not determine fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion and both having reasonable knowledge of relevant facts. This is the comprehensive and long standing definition of fair market value and has been used in innumerable contexts. See, e.g., United States v. Cartwright, 411 U.S. 546, 551 (1973); In re Williams' Estate, 256 F.2d 217, 218 (9th Cir. 1958); Chiu v. Commissioner, 84 T.C. 722, 730-733 (1985). These appraisals merely discussed the (unrealistically) projected income streams purportedly to be received in the future.

For any and all of the foregoing reasons, petitioners have failed to establish their entitlement to the investment tax credits claimed.

Additions to Tax

Section 6653(a)

Because the additions to tax were raised by respondent by Amendment to the Answer, he has the burden of proof as to each of them. Rule 142(a), Tax Court Rules of Practice and Procedure. For the several reasons set forth above, including failure to comply with regulations prescribing timely elections by the lessors, and grossly exaggerated and wholly unsupported claims of fair market value, petitioners are not entitled to the investment tax credits claimed. Those reasons also lead to the conclusion that respondent's burden to establish negligence under section 6653(a) for 1979 and under section 6653(a)(1) for 1982 has been satisfied. As stated by the Court of Appeals for the Ninth Circuit in another tax avoidance context, "[n]o reasonable person would have trusted this scheme to work." Hanson v. Commissioner, 696 F.2d 1232, 1234 (9th Cir. 1983).

The addition to tax for 1979 is applicable if any part of the underpayment is due to negligence. As applicable to 1982, section 6653(a) is divided into two parts, (1) and (2), as follows:

> (1) In general.--If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A, by chapter 12 of subtitle B or by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.
>
> (2) Additional amount for portion attributable to negligence, etc.--There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601--
>
>> (A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1), and
>>
>> (B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

As to the underpayment for 1982 attributable to disallowed deductions, respondent has not satisfied his burden of proof as to the section 6653(a)(2) additional amount. Except to the extent that they are disallowed for lack of substantiation, the deductions represent payments actually made by petitioners, and they are disallowed on a ground that was not necessarily foreseeable to petitioners, i.e., lack of profit objective. They relied, although unwisely, on Pratt, and he was familiar with all of the facts. The addition to tax under section 6653(a)(2), therefore, does not apply to these items. It does apply, however, to that portion of the underpayment that is attributable to the disallowed investment tax credits.

Section 6659

Respondent also seeks an addition to tax for an underpayment attributable to a valuation overstatement, section 6659, and has the burden of proof on that issue. We have no doubt that the amounts set forth on petitioners' 1982 return as qualified investment for purposes of section 48(d) were grossly overstated. In addition, as set forth above, the investment tax credits are not allowable in this case for three reasons, i.e., the lessors' elections to pass through the investment tax credit were not timely filed; petitioners did not prove that either property was placed in service during the taxable year; and petitioners did not prove the fair market value of either property.

Like the appraisers whose opinions as to value were provided to petitioners in 1983, respondent's experts failed to support any conclusion of fair market value in terms of the price at which the property would change hands between a willing buyer and a willing seller, each having reasonable knowledge of relevant facts. We need not, therefore, accept their conclusions. See Helvering v. National Grocery Co., 304 U.S. 282, 295 (1938); Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964), affg. a

Memorandum Opinion of this Court. Both Benjamin Bunny and Pulsator existed; even though promotional and contractual arrangements were unreal, the properties were not fictitious. Respondent has not satisfied us that the actual fair market value of each property is zero (or not more than $500 for Benjamin Bunny), as testified to by his experts. The amount of the overstatement, and the deficiency attributable thereto, cannot, therefore, be determined for purposes of section 6659.

Section 6661

Section 6661 provides:

> SEC. 6661. SUBSTANTIAL UNDERSTATEMENT OF LIABILITY.
>
> (a) Addition to Tax.--If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 10 percent of the amount of any underpayment attributable to such understatement.
>
> (b) Definition and Special Rule.--
>
> (1) Substantial understatement.--
>
> (A) In general.--For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of--
>
> (i) 10 percent of the tax required to be shown on the return for the taxable year or,
>
> (ii) $5,000.

* * *

(2) Understatement.--

(A) In general.--For purposes of paragraph (1), the term "Understatement" means the excess of--

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return.

(B) Reduction for understatement due to position of taxpayer or disclosed item.--The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to--

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(C) Special rules in cases involving tax shelters.--

(i) In general.--In the case of any item attributable to a tax shelter--

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

> (ii) Tax shelter.--For purposes of clause (i), the term "tax shelter" means--
>
> (I) a partnership or other entity,
>
> (II) any investment plan or arrangement, or
>
> (III) any other plan or arrangement,
>
> if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.
>
> (3) Coordination with penalty imposed by section 6659.--For purposes of determining the amount of the addition to tax assessed under subsection (a), there shall not be taken into account that portion of the substantial understatement on which a penalty is imposed under section 6659 (relating to addition to tax in the case of valuation overstatements).

Respondent has satisfied the requirements of this section. The facts found above and discussed in relation to the taxpayers' activity (or inactivity) with respect to Benjamin Bunny and Pulsator compel the conclusion that the principal purpose of the investment plans or arrangements entered into with Cambridge and Century were the avoidance or evasion of Federal income tax. These arrangements fall within the definition of tax shelters; the dollar amounts are met; and none of the reduction provisions apply.

Section 6621(d)

Finally, respondent seeks additional interest under section 6621(d), which provides:

(d) Interest on Substantial Underpayments Attributable to Tax Motivated Transactions.--

(1) In general.--In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).

(2) Substantial underpayment attributable to tax motivated transactions.--For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

(3) Tax motivated transactions.--

(A) In general.--For purposes of this subsection, the term "tax motivated transaction" means--

(i) any valuation overstatement (within the meaning of section 6659(c)),

* * *

(B) Regulatory authority.--The Secretary may by regulations specify other types of transactions which will be treated as tax motivated for purposes of this subsection and may by regulations provide that specified transactions being treated as tax motivated will no longer be so treated. In prescribing regulations under the preceding sentence, the Secretary shall take into account--

(i) the ratio of tax benefits to cash invested,

(ii) the methods of promoting the use of this type of transaction, and

(iii) other relevant considerations.

> (C) Effective date for regulations.--Any regulations prescribed under subparagraph (A)(iv) or (B) shall apply only to interest accruing after a date (specified in such regulations) which is after the date on which such regulations are prescribed.
>
> (4) Jurisdiction of Tax Court.--In the case of any proceeding in the Tax Court for a redetermination of deficiency, the Tax Court shall also have jurisdiction to determine the portion (if any) of such deficiency which is a substantial underpayment attributable to tax motivated transactions.

As discussed above, petitioners are not entitled to the investment tax credits that they claimed for various reasons, including the lack of timely elections by the lessors; the failure to establish that the property was placed in service during 1982; or the failure of petitioners to establish the fair market value of the property. Because respondent has also failed to prove the fair market value of either property, we cannot determine the amount of deficiency "attributable" to the overvaluation. Compare Johnson v. Commissioner, 85 T.C. 469, 484 (1985), where "the valuation overstatements were the sole source and cause of petitioners' deficiency." In this case, therefore, the additional interest will not be applied to the disallowed investment tax credits.

Expenses relating to Mrs. Harmon's ceramics and quilting activities were disallowed because petitioners did not prove that they were entitled to deductions against income from that activity beyond those allowed by respondent. The portion of the deficiencies attributable to those disallowed expenses do not come within the provisions of section 6621(d).

In temporary regulations adopted on December 26, 1984, pursuant to section 6621(d)(3)(B), and stated to be applicable to interest accruing after December 31, 1984, respondent has indicated that "any deduction disallowed for any period under section 183" is subject to the provision for additional interest set forth in section 6621(d). Section 301.6621-2T, A-4(1), Proced. & Admin. Regs, 49 Fed. Reg. 59394 (Dec. 28, 1984). To the extent, therefore, that the deductions claimed by petitioners for "rental" ($13,000) and "advertising" ($5,300) in relation to Benjamin Bunny and Pulsator have been disallowed because we find that petitioners were not engaged in those activities for profit, the temporary regulations provide that the deficiency attributable to those deductions is subject to additional interest under section 6621(d)(1). Unlike that portion of the deficiency represented by the disallowed investment credits, there is no alternative ground advanced by respondent and thus no question as to what defect this portion of the deficiency is attributable.

The temporary regulations were adopted under the authority of section 6621(d)(3)(B) and (C), supra. We have found that the principal purpose of the investment plans or arrangements made by petitioners with respect to Benjamin Bunny and Century were the avoidance or evasion of Federal income tax. In other words, petitioners' activities with respect to Benjamin Bunny and

Pulsator were tax motivated transactions. Thus application of the Temporary Regulations to the deficiencies attributable to disallowance of deductions relating to those activities is consistent with the statute's express provisions and implicit policy. Additional interest in accordance with section 6621(d) will, therefore, apply to the deductions claimed by petitioners for rental and advertising in relation to Benjamin Bunny and Pulsator. The additional interest accrues after December 31, 1984, even though the transactions were entered into prior the date of enactment of section 6621(d). *Solowiejczyk v. Commissioner*, 85 T.C. 552 (1985), on appeal (2d Cir., Mar. 24, 1986).

Decision will be entered under Rule 155.

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UNITED STATES TAX COURT

MARY G. LANE, ET AL.,[1] Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 10430-79, 10431-79, 10432-79. Filed July 23, 1986.

Douglas A. Lane, pro se.

Howard P. Levine, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: Respondent determined deficiencies and additions to tax in petitioners' Federal income taxes as follows:

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[1] The following cases have been consolidated for purposes of trial, briefing, and opinion by our order dated June 5, 1984: Mary G. Lane, docket No. 10430-79; Douglas A. Lane, docket No. 10431-79; Douglas A. Lane, docket No. 10432-79.

G. M.

Docket No. 10430-79--Mary G. Lane[2]

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)[3]	Sec. 6651(a)(1)
1972	$61,907.71	$3,095.35	$15,476.75

Docket No. 10432-79--Douglas A. Lane

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)	Sec. 6651(a)(1)
1972	$61,907.71	$3,095.35	$15,476.75

Docket No. 10431-79--Douglas A. Lane[4]

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)	Sec. 6651(a)(1)
1973	$18,834.89	$ 941.70	$ 4,708.50
1974	634.36	31.71	158.59
1975	3,843.90	192.19	960.97
1976	14,333.95	716.69	3,583.25

After concessions, the issues for decision are: (1) whether Douglas A. Lane (hereinafter petitioner) understated his taxable income for the years 1972, 1973, 1975, and 1976; (2) whether assessment of the deficiency and additions to tax with respect to the 1972 taxable year is barred by the applicable statute of limitations; (3) whether petitioner is liable for the section

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[2] Respondent concedes that petitioner Mary G. Lane is entitled to the benefit of the innocent spouse provision under section 6013(e).

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

[4] Respondent concedes that there is no deficiency in income or additions to tax due from petitioners for the 1974 taxable year.

6651(a)(1) addition to tax for his failure to timely file income tax returns for the years 1972, 1973, 1975, and 1976; and (4) whether any part of petitioner's underpayments of tax for the years in issue were due to negligence or intentional disregard of rules and regulations pursuant to section 6653(a).

FINDINGS OF FACT

Petitioners resided in Bristol, Tennessee when they filed their petitions in these cases. They filed a joint Federal income tax return for the 1972 taxable year with the Internal Revenue Service Center in Memphis, Tennessee on March 6, 1974. Petitioners failed to file Federal income tax returns for the 1973, 1975, and 1976 taxable years.

During the years 1972, 1973, and 1974, petitioner operated a sole proprietorship under the name of Bristol Auto Salvage, which engaged in selling auto salvage goods. He failed to maintain, or to submit for examination by respondent, complete and adequate books and records detailing his income-producing activities. Respondent determined petitioner's income for the 1972, 1973, 1975, and 1976 taxable years on the basis of the bank deposits method of reconstructing income. In addition, for 1972, 1973, and 1976, cash expenditures were used, in addition to bank deposits, to determine petitioner's income. Furthermore, the general ledger for Bristol Auto Salvage was utilized by respondent to determine petitioner's gross receipts and expenses for the 1973 taxable year.

During 1972, petitioner maintained a checking account at the Bank of Virginia (formerly Washington Trust Bank), account number 30-557-3. He deposited $116,674.29 into this checking account during 1972. In addition, he maintained a checking account until August 1972 at the Bank of Virginia (account number 12-567-4) in the name of Bristol Auto Salvage. Petitioner deposited $104,519.08 into that account during the 1972 taxable year. On July 27, 1972, he opened a checking account at the Virginia National Bank (account number 171 3625 4) in the name of Bristol Auto Salvage. The account was maintained through the end of 1972, during which year petitioner deposited $87,628.08 into that account.

The following deposits, made by petitioner in 1972, were identified and allowed by respondent in the notice of deficiency as being from non-taxable sources:

Date	Deposits
Transfers between accounts:	
Bank of Virginia - account number 30-557-3:	
01/03/72	$ 400
01/11/72	1,700
01/21/72	2,500
02/22/72	1,900
03/13/72	600
04/17/72	1,000
10/31/72	150
12/01/72	3,000
	$ 11,250

Bank of Virginia - account number 12-567-4:

01/17/72	$ 500
02/07/72	650
02/15/72	3,500
02/17/72	750
03/23/72	150
04/21/72	250
07/10/72	500
07/24/72	350
	$ 6,650

Virginia National Bank - account number 171 3625 4:

08/08/72	$ 1,000
09/26/72	18,000
10/05/72	400
	$ 19,400
	$ 37,300

Returned check redeposited:

Bank of Virginia - account number 30-557-3:

03/10/72	$ 2,191.56

Bank Loans:

Virginia National Bank - account number 171 3625 4:

07/27/72	$ 20,000.00
Total Non-taxable deposits:	$ 59,491.56

Furthermore, respondent now concedes that the following deposits made by petitioner in 1972 are, in addition to those identified and allowed in the notice of deficiency, from non-taxable sources:

Date	Explanation	Deposits
Bank of Virginia - account number 30-557-3:		
03/31/72	CNA Insurance	$ 14,975

Virginia National Bank - account number 171 3625 4:

10/09/72	$ 1,492
10/30/72	4,750
Total Additional Non-taxable deposits	$ 21,217

Petitioner's gross income for the 1972 taxable year, as determined by respondent from the checking accounts maintained or controlled by him, is $240,064.81, computed as follows:

Name	Deposits
Bank of Virginia - account number 30-557-3:	
Douglas A. Lane	$116,674.29
Bank of Virginia - account number 12-567-4:	
Bristol Auto Salvage	$104,519.08
Virginia National Bank - account number 171 3625 4:	
Bristol Auto Salvage	$ 87,628.08
Total deposits	$308,821.45
Less: Non-taxable deposits	(59,491.56)
	$249,329.89
Plus: Cash expenditures	11,951.92
Gross income per statutory notice	$261,281.81
Less: Concessions at trial	(21,217.00)
Gross income:	$240,064.81

The amount of gross income stated in petitioner's 1972 tax return was $108,542.18, consisting of the following:

	Amounts
Gross receipts from Bristol Auto Salvage (prior to diminution for cost of goods sold)	$ 72,773.05
Wages	18,316.63
Rents	17,452.50
Gross Income [Stated in Return]	$108,542.18

Petitioner maintained a checking account at the Bank of Virginia (account number 30-557-3), which was closed on February 16, 1973. He made deposits totaling $12,585.62 into his account at the Bank of Virginia during the 1973 taxable year. Additionally, on March 20, 1973, petitioner opened a checking account at the Tri-City Bank and Trust Company (account number 040-270-1), which remained active through October 9, 1974. He deposited $99,231.13 into his Tri-City account during the 1973 taxable year.

For 1973, the bank records for Bristol Auto Salvage were inadequate and incomplete. Consequently, respondent determined the 1973 gross receipts for Bristol Auto Salvage from the general ledger maintained by petitioner for that business. Gross receipts for Bristol Auto Salvage, as reflected in the general ledger for the 1973 taxable year, totaled $114,917.60.

The following deposits, made by petitioner in 1973, were identified and allowed by respondent in the notice of deficiency, as being from non-taxable sources:

Date	Deposits
Transfers between accounts:	
Tri-City Bank and Trust Company - account number 040-270-1:	
05/01/73	$ 500.00
10/01/73	500.00
12/06/73	1,000.00
	$ 2,000.00
Per ledger - Bristol Auto Salvage:	
02/22/73	$25,227.40
03/19/73	2,300.00
09/19/73	2,000.00
10/31/73	3,000.00
11/05/73	3,000.00
12/05/73	1,700.00
12/14/73	1,000.00
12/17/73	2,000.00
12/27/73	1,700.00
	$41,927.40
	$43,927.40
Returned check redeposited:	
Bank of Virginia - account number 30-557-3:	
11/23/73	$ 700.00
Bank Loans:	
Tri-City Bank and Trust Company - account number 040-270-1:	
06/27/73	$14,363.17
09/24/73	2,962.99
	$17,326.16

Total non-taxable deposits:	$ 61,953.56

In addition, respondent concedes that the following deposit made by petitioner in 1973 is, in addition to those identified and allowed in the notice of deficiency, from a non-taxable source:

Date	Deposit
Tri-City Bank and Trust Company - account number 040 270 1:	
12/26/73	$ 750.00

Petitioner's gross income for 1973, as determined by respondent from the checking accounts maintained by petitioner and from the general ledger maintained by him for Bristol Auto Salvage, is $181,735.07, computed as follows:

Name	Deposits
Bank of Virginia - account number 30-557-3:	
Douglas A. Lane	$ 12,585.62
Tri-City Bank and Trust Company - account number 040 270 1:	
Doug Lane	$ 99,231.13
General Ledger:	
Bristol Auto Salvage	114,917.60
Total deposits	$226,734.35
Less: Non-taxable deposits	(61,953.56)
	$164,780.79
Plus: Cash expenditures	17,704.28

Gross income per statutory notice	$182,485.07
Less: Concessions at trial	(750.00)
Gross income	$181,735.07

In addition, petitioners' taxable income for 1973, as determined by respondent, is $41,749.18, computed as follows:

Gross income		$181,735.07
Less:	Business expenses	(136,735.89)
	Standard deduction	(1,000.00)
	Personal exemptions	(2,250.00)
		$ 41,749.18

On October 18, 1974, petitioner opened a checking account at the First Tennessee National Bank, account number 106 6750478. This account remained active through May 18, 1976, and during the 1975 taxable year, petitioner made deposits into this account totaling $59,728.93.

The following deposits, made by petitioner in 1975, were identified by respondent as being from non-taxable sources:

Date	Deposits
Returned checks redeposited:	
First Tennessee Bank - account number 106 6750478:	
06/16/75	$ 750.00
11/24/75	300.00
	$ 1,050.00

Proceeds from insurance:

First Tennessee Bank - account number 106 6750478:	
01/17/75	$ 2,326.22
Total non-taxable deposits:	$ 3,376.22

In addition, respondent concedes that the following deposits in 1975 are, in addition to those identified and allowed in the notice of deficiency, from non-taxable sources:

Date	Payor	Deposits
First Tennessee Bank - account number 106 6750478:		
04/29/75	Leonard Hall	$ 125.00
05/12/75	Todd Real Estate Co.	1,300.00
12/01/75	Inez Lane	1,200.00
Total additional non-taxable deposits:		$ 2,625.00

Petitioner's gross income for the 1975 taxable year, as determined by respondent from the checking accounts maintained by petitioner, is $53,727.71, computed as follows:

	Deposits
First Tennessee Bank - account number 106 6750478	$ 59,728.93
Less: Non-taxable deposits	(3,376.22)
Gross income per statutory notice	$ 56,352.71
Less: Concessions at trial	(2,625.00)
Gross income	$ 53,727.71

In addition, petitioner's taxable income for 1975, as determined by respondent, is $12,030.53, computed as follows:

Gross income	$ 53,727.71
Less: business expenses	(41,697.18)
Taxable income	$ 12,030.53

During the 1976 taxable year, petitioner deposited $2,735.62 into the checking account that he maintained at the First Tennessee National Bank (account number 106 6750478). Additionally, on April 16, 1976, petitioner opened a checking account at the Dominion National Bank (account number 237-664-80) which remained active through January 6, 1977. During the 1976 taxable year, petitioner deposited $47,230.83 into his Dominion National checking account.

The following deposits, made by petitioner in 1976, were identified by respondent in the notice of deficiency as being from non-taxable sources:

Date	Deposits
Bank credits:	
First Tennessee Bank - account number 106 6750478:	
01/02/76	$ 10.00
01/02/76	10.00
01/05/76	565.00
	$ 585.00

Proceeds from insurance:

Dominion National Bank - account number 237 664 8:

04/20/76	$ 1,208.47
Total non-taxable deposits:	$ 1,793.47

In addition, respondent concedes that the following deposits in 1976 are, in addition to those identified and allowed in the notice of deficiency, from non-taxable sources:

Date	Payor	Deposits
First Tennessee Bank - account number 106 6750478:		
05/13/76	Frank Cava judgment	$ 1,039.25
10/18/76	State of Tennessee	25.00
Total additional non-taxable deposits		$ 1,064.25

Petitioner's gross income for the 1976 taxable year, as determined by respondent from the checking accounts maintained by petitioner, is $50,399.97, computed as follows:

Name	Deposits
First Tennessee Bank - account number 106 6750478:	
Douglas A. Lane	$ 2,735.62
Dominion National Bank - account number 237 664 8:	
Doug Lane	$ 47,230.83
Total deposits	$ 49,966.45

Less: Non-taxable deposits	(1,793.47)
	$ 48,172.98
Plus: Cash expenditures	3,291.24
Gross income per statutory notice	$ 51,464.22
Less: Concessions at trial	(1,064.25)
Gross income	$ 50,399.97

In addition, petitioner's taxable income for 1976 as determined by respondent, is $32,763.47, computed as follows:

Gross income	$ 50,399.97
Less: business expenses	(15,486.50)
standard deduction	(1,400.00)
personal exemption	(750.00)
Taxable income	$ 32,763.47

In order to establish that petitioner omitted in excess of 25 percent of the amount of gross income stated on his 1972 tax return for purposes of section 6501(e)(1)(A), respondent filed a motion on November 20, 1979 pursuant to Rule 37(c)[5], requesting entry of an order that the undenied affirmative allegations of fact contained in paragraphs 7(a)(1) to 7(a)(13), inclusive, of respondent's answer, be deemed admitted for that year. In such paragraphs, respondent alleged as follows:

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[5] Unless otherwise indicated, all rule references are to the Tax Court Rules of Practice and Procedure.

7. FURTHER ANSWERING the petition, and as a defense to the assignment of error that the statute of limitations bars the assessment and collection of the deficiencies in income taxes due from the petitioner for the taxable year 1972, the respondent alleges:

(a) The income tax due from the petitioner for the taxable year 1972 may be timely assessed under the provisions of section 6501(e)(1)(A) of the Internal Revenue Code of 1954, in support of which the respondent alleges:

(1) The petitioner and her husband filed a joint income tax return for the taxable year 1972 on March 6, 1974.

(2) During the taxable year 1972 the petitioner's husband was engaged in the business of selling auto salvage under the name of Bristol Auto Salvage and also was engaged in the business of renting property.

(3) During the taxable year 1972 the petitioner's husband derived unreported taxable income from the aforementioned business activities.

(4) During the taxable year 1972 the petitioner's husband failed to maintain, or to submit for examination by the respondent, complete and adequate books of account and records of his income-producing activities as required by applicable provisions of the Internal Revenue Code of 1954 and the regulations promulgated thereunder.

(5) The records maintained by or on behalf of the petitioner and her husband for the taxable year 1972 were inadequate in that they were incomplete and failed to disclose all receipts and did not properly reflect correct taxable income of the petitioner.

(6) Although requested to do so, the petitioner-husband failed and refused to make all of his records which he did maintain available to the agents of the respondent.

(7) The amount of gross income stated in the income tax return filed by the petitioner and her husband for the taxable year 1972 was $108,542.18, consisting of the following:

Gross receipts from Bristol Auto Salvage (prior to diminution for cost of goods sold)	$ 72,773.05

Wages	$ 18,316.63
Rents	17,452.50
Gross income stated in return	$108,542.18

(8) The respondent has determined that petitioner's gross income and taxable income for the taxable year 1972 on the basis of the bank deposits method.

(9) The amounts of petitioner's gross income, the gross income reported on her income tax return, and the understatement of gross income for the taxable year 1972 are as follows:

Gross deposits into bank:	
Bank of Virginia #30-557-03	$116,674.29
Bank of Virginia #12-567-4	104,519.08
Virginia National Bank #171-3625-4	87,628.08
Total gross deposits	$308,821.45
Less non-taxable deposits:	
Transfers between accounts	$ 37,300.00
Returned checks redeposited	2,191.56
Bank loans	20,000.00
Total non-taxable deposits	(59,491.56)
Total net deposits from sales	$249,329.89
Taxes withheld from wages	$ 4,152.22
Business expenses paid by cash	7,799.70
Total gross receipts	$261,281.81
Less amounts reported on return	(108,542.18)
Unreported gross income	$152,739.63

(10) In addition to the amounts reported on the return, petitioner and her husband received during the taxable year 1972 the amount of $152,739.63 which was not included in the gross income stated in the return filed by the petitioner for said year and there was not disclosed on the return or in a statement attached thereto the fact that this amount was received during said year.

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(11) The $152,739.63 received by the petitioner and her husband during 1972 is properly includible in gross income for the taxable year 1972.

(12) The $152,739.63 of gross income which petitioner received and which was omitted from the return filed by the petitioner for the taxable year 1972 is in excess of 25 percent of the gross income stated in said return.

(13) The statutory notice determining the deficiency in income tax against the petitioner for the taxable year 1972 was sent to the petitioner by certified mail on April 15, 1979, which date was prior to the expiration of the six-year period of limitations applicable under section 6501(e)(1)(A) of the Internal Revenue Code of 1954.

Petitioners did not reply to respondent's motion and, on January 9, 1980, this Court entered an order granting respondent's motion and deeming admitted "the undenied affirmative allegations of fact contained in paragraphs 7(a) of respondent's answer."

OPINION

Issue 1. Income Tax Deficiencies

The first issue for decision is whether petitioner had unreported income during the 1972, 1973, 1975, and 1976 taxable years. Respondent determined the amount of the deficiencies for each of the years in issue by using the bank deposits-cash expenditures method of reconstructing income. A taxpayer is required to maintain records sufficient to show whether or not he is liable for Federal income taxes. Section 6001. The records maintained by petitioner are insufficient to permit an accurate computation of petitioners' income tax liability for the years in issue. It is well-established that where the taxpayer fails to maintain adequate records, the Commissioner may prove the existence and amount of unreported income by any method that will, in his opinion, clearly reflect the taxpayer's income. Section 446(b); Holland v. United States, 348 U.S. 121, 130-132 (1954); Harper v. Commissioner, 54 T.C. 1121 (1970). The use of the bank deposits method has long been an accepted method of reconstructing a taxpayer's income. Nicholas v. Commissioner, 70 T.C. 1057, 1065 (1978); Estate of Mason v. Commissioner, 64 T.C. 651, 656 (1975), affd. 566 F.2d 2 (6th Cir. 1977).

In a bank deposits reconstruction of the taxpayer's income, the Commissioner's agents review and analyze the taxpayer's bank records for the years in issue. The premise underlying this reconstruction method is that, absent some explanation, a taxpayer's bank deposits represent taxable income. The total of all deposits is determined by the Commissioner for each year in question to arrive at the taxpayer's gross income. An adjustment is then made to eliminate deposits that reflect non-income items such as gifts, loans, and transfers between the taxpayer's various bank accounts. The Commissioner will also make a further adjustment for the taxpayer's ascertainable business expenses, deductions, and exemptions. See Percified v. United States, 241 F.2d 225 (9th Cir. 1957).

In these cases, respondent used a variation of the bank deposits method whereby the taxpayer's cash expenditures are added to his bank deposits in order to determine gross income.

Gromacki v. Commissioner, 361 F.2d 727, 728-729 (7th Cir. 1966); Harper v. Commissioner, 54 T.C. 1121, 1129 (1970).[6] Where respondent has employed this method in his determination of the deficiencies, the burden of proof rests with petitioner to show that such determination was erroneous. Rule 142(a); Estate of Mason v. Commissioner, supra at 657; Harper v. Commissioner, supra at 1129. When, in such a case, petitioner has the burden of proof, the Commissioner need not prove a likely source for the unreported income. Estate of Mason v. Commissioner, supra at 657. Nor is he required to prove that all deposits constitute taxable income. Gemma v. Commissioner, 46 T.C. 821 833 (1966). The burden of showing duplications is on the taxpayer. Zarnow v. Commissioner, 48 T.C. 213, 216 (1967).

During 1972, 1973, and 1974, petitioner operated a sole proprietorship under the name of Bristol Auto Salvage, engaging in the business of selling auto salvage. During the years in issue numerous checking accounts were maintained by petitioner at several different banking institutions. Although petitioner reported only $108,542.18 in gross income on his 1972 income tax return, total deposits to the three checking accounts maintained by him in 1972 totaled $308,821.45. Likewise, gross income for the 1973 taxable year, as determined by respondent from the checking accounts maintained by petitioner for Bristol Auto

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[6] See also Kindred v. Commissioner, T.C. Memo. 1979-457, affd. 669 F.2d 400 (6th Cir. 1982); Asmar v. Commissioner, T.C. Memo. 1976-213; Baker v. Commissioner, T.C. Memo. 1976-93.

Salvage, totaled $226,734.35. For the 1975 and 1976 taxable years, the total deposits to petitioner's checking accounts were $59,728.93 and $49,966.45, respectively. Although he had substantial sources of income during the taxable years in issue, he substantially understated gross income on his 1972 income tax return and failed to file income tax returns for the years 1973, 1975, and 1976.

Large and frequent deposits were made to petitioner's bank accounts during the years in issue, but no explanation supporting a non-taxable source has been offered by petitioner. In addition, although petitioner would not stipulate to his own bank records, he conceded their authenticity at trial. He submitted four exhibits at trial to refute respondent's deficiency determinations. The first two exhibits, however, relate to a year not in controversy. With respect to the third exhibit, the record was left open by the Court for 30 days in order to allow petitioner an opportunity to verify the basis of the property purportedly sold at cost during one of the years in issue. To our knowledge, he has not provided such information. As to the fourth exhibit, respondent conceded at trial that the amount in question represented a non-taxable source of income from insurance proceeds.

Although we are generally sensitive to the plight of the pro se taxpayer in a complicated reconstruction of income matter such as this, petitioner simply has not met his burden of proving that respondent's determinations are in error. Thus, based on the substantial amounts of unexplained bank deposits and the inadequacy of petitioner's records, we sustain the deficiencies in income taxes determined by respondent for the years in issue.[7]

Issue 2. Statute of Limitations

The 1972 Federal income tax return was filed by petitioners on March 6, 1974. The statutory notice of deficiency with respect to that taxable year was not issued until April 13, 1979, well after the expiration of the normal 3-year statutory period during which the Commissioner must assess the tax. Section 6501(a). An exception to the normal 3-year statute of limitations is found in section 6501(e)(1)(A) which provides as follows:

> (e) Substantial Omission of Items.--Except as otherwise provided in subsection (c)--
>
> > (1) Income Taxes.--In the case of any tax imposed by subtitle A--
> >
> > > (A) General Rule.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph--
> > >
> > > > (i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or

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[7] We note that respondent filed a motion pursuant to Rule 37(c) requesting that the undenied allegations of fact contained in paragraph 7(a) of his answer be deemed admitted. We granted this motion on January 9, 1980. The figures contained in paragraph 7(a) relate to respondent's determination of the deficiency for 1972 and do not include the concessions later made by respondent regarding certain non-taxable deposits that were not reflected in the notice of deficiency for the year 1972.

> services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> (ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Thus, the Commissioner has a 6-year period for assessment on income tax returns from which an amount in excess of 25 percent of the gross income reported has been omitted. Respondent has the burden of proving the facts necessary to show that the 6-year statute of limitations period applies. Bardwell v. Commissioner, 38 T.C. 84, 92 (1962), affd. 318 F.2d 786 (10th Cir. 1963); Reis v. Commissioner, 1 T.C. 9, 13 (1942). Therefore, respondent must establish that petitioners omitted an amount in excess of 25 percent of the gross income stated on the 1972 tax return. We find that respondent has sustained his burden of proof. In his answer, respondent affirmatively alleged facts supporting an omission from gross income of $152,739.63, which was well in excess of 25 percent of the gross income stated ($108,542.18) in petitioner's 1972 tax return. Pursuant to Rule 37(c), respondent timely filed a motion requesting entry of an order that certain undenied allegations of fact contained in his answer be deemed admitted. By our order dated January 9, 1980, the undenied affirmative allegations of facts contained in paragraph 7(a) of respondent's answer were deemed admitted.

The facts herein clearly satisfy respondent's burden of proving a 25 percent omission for purposes of section 6501(e).[8] Accordingly, we hold for respondent on this issue.

Issue 3. Section 6651(a)(1) Additions to Tax

The next issue for decision is whether petitioner is liable for the additions to tax under section 6651(a)(1) for failing to timely file his income tax returns for the years in issue.[9] Petitioner's 1972 income tax return was due on or before April 15, 1973. Section 6072(a). However, two extensions of time for filing the return to September 15, 1973, were secured by petitioner. He ultimately filed his 1972 income tax return on March 6, 1974, which was more than 5 months after the due date.

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[8] In Doncaster v. Commissioner, 77 T.C. 334 (1981), we held that the Commissioner's burden of proof with respect to the section 6653(b) addition to tax for fraud can be satisfied through undenied facts deemed admitted under Rule 37(c).

[9] Sec. 6651(a)(1) provides as follows:

> (a) Addition to the Tax.--In case of failure--
> (1) to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of Subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

For the taxable years 1973, 1975, and 1976, petitioner failed to file income tax returns, although he was required to file such returns pursuant to section 6012.

Petitioner bears the burden of proving that his failure to timely file his tax returns for the years in issue was "due to reasonable cause and not due to willful neglect," within the meaning of section 6651(a). Rule 142(a); Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324, 1342 (1971), affd. without published opinion 496 F.2d 876 (5th Cir. 1974). He offered no explanation for the delinquent filing of his 1972 return or for his failure to file returns for the 1973, 1975 and 1976 taxable years. Accordingly, we sustain respondent's determination that petitioner is liable for the additions to tax under section 6651(a)(1) for all of the years in issue.

Issue 4. Section 6653(a) Additions to Tax

The final issue for decision is whether petitioner is liable for the additions to tax for negligence or intentional disregard of rules or regulations under section 6653(a) for each of the years in issue.[10] Petitioner failed to maintain books or records sufficient to accurately establish the amount of gross income for the years in issue. In addition, he substantially understated his gross income on his 1972 income tax return, and failed to file income tax returns for the 1973, 1975, and 1976 taxable years.

Petitioner has the burden of proving error in respondent's determination that the section 6653(a) additions to tax should be imposed against them. Rule 142(a); Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972); Enoch v. Commissioner, 57 T.C. 781, 802 (1972). A taxpayer must maintain such permanent books and records as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown on his tax return. Section 6001 and section 1.6001-1(a) and (e), Income Tax Regs. Petitioner's failure to keep the records necessary to properly report his income for the years in issue is indicative of his negligence. Smith v. Commissioner, 66 T.C. 622, 651 (1976), revd. and remanded 601 F.2d 196 (5th Cir.

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[10] Sec. 6653(a) provides as follows:

> (a) Negligence or Intentional Disregard of Rules and Regulations with Respect to Income, Gift, or Windfall Profit Taxes--
>
> (1) In General.--If any part of any underpayment (as defined in subsection (c)(1) of any tax imposed by subtitle A, by chapter 12 of subtitle B or by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

1979). Furthermore, a substantial understatement of income has been held to be indicative of negligence or intentional disregard of the rules or regulations. See Anders v. Commissioner, 68 T.C. 474, 493 (1977).

Accordingly, we sustain respondent's determination and hold that petitioner is liable for the additions to tax under section 6653(a) for each of the years in issue.

To reflect concessions and our conclusions with respect to the disputed issues,

Decisions will be entered
under Rule 155.

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T. C. Memo. 1986-307

UNITED STATES TAX COURT

ESTATE OF ANTHONY CARDULLA, Deceased and MARY CARDULLA, SURVIVING WIFE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13097-79. Filed July 23, 1986.

Richard J. Cardulla, for the petitioners.

Ruth E. Salek, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: Respondent determined the following deficiencies and additions to tax in petitioners' income tax for their 1973, 1974, and 1975 taxable years:

Year	Deficiency	Addition to tax Sec. 6653(b)[1]
1973	$ 10,952.48	$ 5,476.24
1974	27,361.13	13,680.57
1975	18,130.86	9,065.43

The issues presented for our decision are: whether petitioners omitted from their 1973, 1974, and 1975 Federal income tax returns taxable income in the respective amounts of $33,213.67, $57,853.50, and $48,542.23; (2) whether any part of the underpayment of tax for petitioners' 1973, 1974, and 1975 taxable years is due to fraud; (3) whether respondent is barred by the statute of limitations from assessing tax liability for the Cardullas' 1973, 1974, and 1975 taxable years; and (4) whether Mrs. Cardulla is entitled to relief from liability under section 6013(e) for any deficiency.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The first stipulation for trial as modified by our order of July 6, 1983, and the attached exhibits are incorporated herein by this reference.

Although the petition in the instant case was filed on September 10, 1979, it was nearly 4 years before this case was finally brought to trial. The attorney for petitioners was persistently unwilling to engage in the stipulation process as required by Rule 91.[2] On February 3, 1981, respondent issued to petitioners Respondent's Requests for Admission; Respondent's Request for Production of Documents; and Respondent's Interrogatories to Petitioners. Petitioners responded to respondent's requests on February 23, 1981 and also issued "Petitioners' Request for Production of Documents." Petitioner's response, however, was entirely inadequate and on March 26, 1981 respondent filed a motion to compel answers to admissions or to impose sanctions. On August 11, 1981, this Court issued an order directing compliance with the discovery motions issued by the respective parties.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

On January 6, 1982, respondent filed with this Court a motion for summary judgment primarily because, as of that date, petitioners had failed to respond to the interrogatories or admissions as required by this Court's August 11, 1981 order. A hearing was held on March 8, 1982, at which time the parties agreed that respondent would withdraw his motion for summary judgment and that petitioners would file complete answers to the interrogatories and admissions on or before April 16, 1982. As a further result of the March 1982 hearing, this Court ordered the parties to file a stipulation of facts on or before September 15, 1982. Petitioners again failed to timely respond to respondent's interrogatories and Requests for Admission. Petitioners also failed to cooperate in developing a stipulation as required by this Court's Rules of Practice and Procedure.

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[2] Unless otherwise indicated, all rule references are to the Tax Court Rules of Practice and Procedure.

A pretrial hearing was held before this Court on December 8, 1982, at which time the parties were again ordered to confer for as long as necessary in order to reach an agreement on a stipulation of facts. By the close of the day, the attorneys for both parties had agreed to a first stipulation for trial which was dispositive of all but four issues. On December 10, 1982, respondent sent to petitioners the first stipulation for trial reflecting the agreement of December 8, 1982. On December 20, 1982, however, the attorney for petitioners sent respondent a letter indicating that he was unwilling, despite his earlier agreement, to sign the stipulation.

On May 24, 1983, respondent filed pursuant to Rule 91(f)(1), a motion for order to show cause why proposed facts and evidence should not be accepted as established. This motion was heard at a pretrial conference held on June 7, 1983. As a result of this hearing, we ordered that the stipulation and accompanying documents pertaining to respondent's motion under Rule 91(f) be deemed stipulated with certain exceptions noted in our order of July 6, 1983.

Petitioner Mary Cardulla (hereafter "Mary") resided at Star-Route, Box 59, Ramona, California, when she filed the petition herein. Mr. and Mrs. Cardulla timely filed their

Federal income tax returns for the taxable years 1972, 1973, 1974, and 1975. They reported their taxable income on these returns in the amounts of $16,569, $13,957, $18,578, and $8,865, respectively.

During each of the taxable years in issue, the Cardullas operated a retail salvage business under the name of Cardulla Sales. In 1975, Cardulla Sales was in the process of winding down its business operations. Decedent's principal place of business was located at 6560 Break of Day Road, Victor, New York. The Cardullas' Federal income tax returns were filed on the cash method of accounting for the taxable years in issue.

Mr. Cardulla told respondent that he reported all the income he earned and that his income was derived solely from the sale of salvaged goods and small amounts of interest from his and his wife's savings accounts. The Cardullas, however, also earned taxable income from the following sources that are in addition to those disclosed by Mr. Cardulla: (1) fees paid by Lehigh Valley Railroad and the Erie Lackawanna Railroad to remove debris from their railroad tracks after train derailments; (2) proceeds from the sale of meat during 1974; (3) rental income; and (4) dividend income.

The Cardullas failed to maintain adequate books and records of their income producing activities for the 1973, 1974, and 1975 taxable years. The amounts of taxable income, deductions and other items required to be shown on the Cardullas' income tax returns for each of the taxable years in issue could not be determined from the records maintained by decedent and submitted for examination by respondent. Respondent issued a 90-day notice of deficiency to the Cardullas on June 19, 1979. Respondent reconstructed the Cardullas' income by the use of the net worth and personal expenditures method.[3]

Decedent and Mary's income tax returns for the taxable years 1973, 1974, and 1975 were prepared by public accountant, Sidney Galinsky, in Rochester, New York. Mr. Galinsky based his preparation of the Cardullas' tax returns on an analysis of their bank statements, check registers, deposit slips, and the cancelled checks from their checking account. After Mr. Galinsky prepared these income tax returns, Mr. Cardulla would review the return and discuss any questionable items. The return was then verified and signed by decedent and Mrs. Cardulla.

The Cardullas maintained 28 bank accounts during the years 1973, 1974, and 1975. Some of these accounts were held jointly by the Cardullas, some were held individually by either Mary Cardulla or Anthony Cardulla, Sr., and still others were held by Mr. or Mrs. Cardulla in trust for their grandchildren.

In 1974, decedent received $37,000 from the sale of meat to a store owner in Binghamton, New York. Mr. Cardulla told respondent's investigators that he deposited the $37,000 amount into his Marine Midland business checking account with a notation on the deposit slip indicating that the amount represented a loan. Mr. Cardulla also told his accountant, Sidney Galinsky, that the $37,000 was a loan and, accordingly, the accountant did not report the amount as income on petitioners' income tax returns for any of the years in issue. During an interview conducted during respondent's investigation, however, Mr. Cardulla told Special Agent Randy Vaughn that if the $37,000 was not reported on his return, it was due to his accountant's error.

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[3] Respondent concedes that petitioner Mary Cardulla is not liable for the addition to tax pursuant to sec. 6653(b) for fraud for any of the taxable years in issue.

The Cardullas' income tax returns for the taxable years 1969, 1970, and 1971 were previously audited by the Internal Revenue Service. As a result of that audit, Mr. Cardulla changed the method he used to report inventory on his returns. Prior to the audit, Mr. Cardulla determined the value of his inventory by including both the amounts actually paid for inventory during the taxable year and also any accounts payable on the items purchased from the railroads that were outstanding at year end. As a result of the audit that occurred in 1969, 1970, and 1971, Mr. Cardulla was advised by his accountant that because he was a cash basis taxpayer he should value his inventory at cost. The Cardullas' 1971 closing inventory value was derived from an agreement that was made with the Internal Revenue Service following the audit for the taxable years 1969 through 1971. The closing inventory amount agreed upon was used by Mr. Cardulla for opening inventory on the Cardullas' 1972 return.

Decedent told respondent during an interview on August 25, 1976, that at the end of each of the taxable years in issue, he would take a physical count of all the merchandise in each of his warehouses and in the barns located at his home. Mr. Cardulla valued the inventory according to the lesser of either the price paid for each item or its fair market value. The revenue agent determined that the amounts on Mr. Cardulla's cancelled checks corresponded with the amounts reported by the Cardullas on their tax returns for each of the years in issue. The inventory values used by respondent on their net worth computation for each of the taxable years in issue were taken directly from Mary and Anthony Cardullas' 1972, 1973, 1974, and 1975 Federal income tax returns.

Mr. Cardulla failed to inform his accountant, Mr. Galinsky, of the income producing property purchased by the Cardullas, in California, in 1973. In addition, Mr. Galinsky was never advised of the official bank checks purchased with business receipts, but deposited into the Cardullas' personal accounts. Furthermore, Mr. Cardulla failed to advise respondent's investigating agents of the assets owned by he and his wife in various states when such information was requested. Mr. Cardulla told respondent that the only assets he owned consisted of property located at 6560 Break of Day Road, Victor, New York, which decedent purchased for $7,000, a warehouse located on Maple Avenue in

Victor, New York, which Anthony Cardulla built in 1974 at a cost of $41,120, a 1970 Chevrolet, and a paid up life insurance policy with Metropolitan Life Insurance Company.

In addition to the assets that Mr. Cardulla disclosed to respondent, the Cardullas owned two lots in Lehigh, Florida, which were purchased for $3,410. The Cardullas also owned property on East Victor Road in Victor, New York, which they purchased for $4,500, but which was sold in 1975. In 1973, the Cardullas purchased a six-unit apartment building located at 5050 West Point Loma Boulevard, San Diego, California, for $114,000. The building itself was valued at $100,000. In 1974, Mr. Cardulla and his son Anthony, Jr. had new carpeting installed in the apartment building at a cost of $5,280. The carpeting was obtained by Mr. Cardulla through an exchange of inventory with a carpet supply house. Box springs and mattresses were also purchased for the apartment building in 1973 at a cost of $880.

In 1975, the Cardullas purchased 26 acres of land on Earlham Street in Ramona, California, for $76,500. In 1950, decedent built several barns in Victor, New York, at a cost of $20,000. Mr. Cardulla had at one time been in the business of raising poultry and the barns were used for this purpose. During the taxable years in issue, the barns were used for storage purposes. The Cardullas purchased a Mercedes Benz in 1975 for $9,800, and a Fiat in 1974 for $3,650, which was later given to their son.

Mr. Cardulla told respondent's investigators that he did not have any loans or mortgages outstanding. However, during the 1972 taxable year, the Cardullas had an outstanding note payable to Marine Midland Bank in the amount of $5,000. In addition, the Cardullas borrowed $54,500 from Michael A. Bernstein and Sharon Ruth Bernstein on April 18, 1975; $52,372.91 of this amount was still outstanding as of December 31, 1975. Furthermore, as of December 31, 1973, the Cardullas had an outstanding mortgage with Home Federal Savings and Loan on which they owed $40,596.80, $37,616.87, and $29,220.69 at the end of the 1973, 1974, and 1975 taxable years, respectively.

During an interview with respondent's investigators on May 3, 1976, Mr. Cardulla said that it was his practice to deposit all business receipts into his business checking account. However, when asked about a $12,946.79 deposit to his savings account during the interview, Mr. Cardulla indicated that although the money came from the sale of merchandise, it did not constitute income because he was merely replacing money which he had withdrawn from his personal savings account for business purposes. Mr. Cardulla admitted, however, that the personal funds that he had initially used to pay business expenses were claimed as business deductions on his Federal income tax return. The $12,946.79 was not reported on petitioners' tax returns for any of the taxable years in issue. Decedent told the revenue agent that the $12,946.79 was deposited to his personal savings account at Community Savings Bank so that the funds would earn interest for him.

During an interview with decedent, respondent reviewed with Mr. Cardulla the Marine Midland Bank official checks purchased by Mr. Cardulla during the years in issue. This review revealed that Mr. Cardulla frequently used business receipts to purchase personal assets through the use of official bank checks.

The Cardullas supplied financial information to Home Federal Savings and Loan that was used for the preparation of a personal financial statement that was signed by Mr. and Mrs. Cardulla on May 21, 1973. The Home Federal financial statement was prepared pursuant to verbal statements made by the Cardullas regarding the value of his property. The financial statement indicated assets totaling $791,067.

During each of the years in issue, Mr. Cardulla was the salvage agent for the Lehigh Valley Railroad and the Erie Lackawanna Railroad. When a derailment occurred, Mr. Cardulla was contacted by the railroad. Decedent had two or three permanent employees, but it was also necessary to hire additional workers at the job site. Most of the train derailments occurred in the early morning, generally during the coldest periods of the year when the switches and track would become brittle. Many derailments occurred during the holiday season because railroad employees had a tendency to run the train at higher speeds during this period in order to get home faster.

Mr. Cardulla and the other employees of Cardulla Sales were responsible for salvaging as much merchandise from the train derailment as possible. Their objective was to remove the merchandise from the tracks as quickly as possible so that the railroad could resume its normal operation. Cardulla Sales was compensated by the railroads for their assistance in clearing the tracks of debris. In addition, Cardulla Sales purchased the damaged merchandise from the railroad that had been removed from the tracks. The railroad would make a record of everything that decedent and his employees removed from the scene of the derailment. The merchandise that was not destroyed or damaged was sent on to its original destination, and Mr. Cardulla removed the remaining damaged goods to his warehouse where the items were stored until they could ultimately be resold. The railroad then sent Mr. Cardulla a letter describing the specific items removed by Cardulla Sales. The railroad valued the goods that were salvaged by Cardulla Sales by using the invoices prepared by the various consignees and by reviewing past claims.

The amount paid by Cardulla Sales for the salvaged items was also based on the condition of those items at the time of their removal. The process by which Mr. Cardulla and the railroad negotiated a settlement concerning the value of the salvaged goods generally lasted 3 or 4 months. It was generally 3 months before the railroad was paid by Mr. Cardulla for the items purchased by Cardulla Sales for resale. Cardulla Sales paid Lehigh Valley Railroad between $20,000 and $40,000 during each of the taxable years in issue. Some of the salvaged merchandise would be sold in the Cardulla's retail store while other items would be sold wholesale. Decedent sold a variety of goods including foodstuffs, building materials, and electrical appliances. Although Cardulla Sales was in the process of winding down its business operation in 1975, the Cardullas were involved in a large derailment in Leroy, New York, in the early part of 1976.

Petitioner Mary Cardulla worked as a sales clerk at Cardulla Sales during all of the years in issue. Mrs. Cardulla maintained bank accounts and bonds in her own name, jointly with her husband and in trust for some of her grandchildren. She signed the income tax returns for each of the years in issue, but had no other involvement in either the preparation of these returns or her husband's business affairs.

Through interviews of Mr. Cardulla and through inventories taken of petitioners' safe deposit box and safe, respondent determined that Mr. Cardulla had $13,806.40 in cash on hand. The decedent told respondent's investigators that the $13,806.40 amount remained constant from the commencement of his business until its termination in the middle of 1976. The amount of cash increased to $63,806.40 during the year 1972. These additional funds were used by the Cardullas to purchase an apartment complex in San Diego, California, in 1973. The cash on hand was used by decedent to pay the business expenses associated with a train derailment, such as the wages paid to temporary employees who insisted that they be paid in cash. After each expenditure, the amount of cash expended was replaced by Mr. Cardulla.

The Cardullas purchased a New York City Bond with a maturity date of July 1, 1987, a face value of $10,000 and a 5-1/4 percent annual yield. Petitioners admit that this bond was outstanding during the 1973, 1974, and 1975 taxable years. Petitioners argued at trial and on brief however, that despite their admission to the contrary, the bond in question was paid in full on January 22, 1973. Respondent has included this bond in its net worth calculations for each of the 3 years in issue.

The Cardullas established certain trust accounts pursuant to the Uniform Gift to Minors Act for the benefit of the Cardullas' grandchildren. The following is a schedule of deposits for the custodial bank accounts maintained by Mary and Anthony Cardulla for their various family members during the years in issue:

Bank	Acct. No.	1972	1973	1974	1975	Acct. Total
Community Svgs.	413-0579	0	0	0	$ 500.00	$ 500.00
Community Svgs.	413-0580	0	0	0	500.00	500.00
Community Svgs.	413-0581	0	0	0	500.00	500.00
Community Svgs.	413-0582	0	0	0	500.00	500.00
Community Svgs.	413-0814	0	0	0	500.51	500.51
Community Svgs.	413-0815	0	0	0	500.51	500.51
Subtotal Community Savings		0	0	0	$3,001.02	$3,001.02
Columbia Bnkg.	6-000558	1,200	1,000	0	1,000.00	3,200.00
Columbia Bnkg.	6-000559	1,200	1,000	0	1,000.00	3,200.00
Columbia Bnkg.	6-200818	0	0	0	3,500.00	3,500.00
Columbia Bnkg.	6-200819	0	0	0	3,500.00	3,500.00
Subtotal Columbia Bnkg.		$2,400	$2,000	0	$9,000.00	$13,400.00
Rochester Svgs.	111-002-546	0	0	0	1,000.00	1,000.00
Rochester Svgs.	111-002-547	0	0	0	1,000.00	1,000.00
Subtotal Rochester Svgs.		$ 0	0	0	$2,000.00	$2,000.00
TOTALS		$2,400	$2,000	0	$14,001.02	$18,401.02

During the years in issue, the Cardullas maintained a savings account (#P514-71876-5) at the Marine Midland Bank. The total amount in this account during the taxable years in issue was $10,000, which reflected a deposit made in 1975. The account was maintained as security for a performance bond relating to the work that petitioners performed for the Erie Lackawanna Railroad during the years in controversy.

The following table reflects the Commissioner's present position with respect to petitioners' net worth and taxable income for the taxable years in issue. Petitioners essentially agree with respondent's net worth reconstruction except for the following six exceptions: the Marine Midland account held in escrow, the bank accounts held in trust for petitioners' grandchildren, the New York City Bond, petitioners' inventory, cash on hand, and depreciation.

	ASSETS	12-31-72	12-31-73	12-31-74	12-31-75
1.	Cash on hand	$63,806.40	$13,806.40	$13,806.40	$13,806.40
	CASH IN BANKS				
2.	Marine Midland Checking Account #544-80639-5	-0-	-0-	-0-	-0-
3.	Marine Midland Checking Account #546-80226-5	(2,047.12)	373.45	5,558.01	1,299.08
4.	Marine Midland Savings Account #501-57032-2	650.22	687.07	715.75	1,815.93
5.	Marine Midland Savings Account #502-68289-2	4,309.85	-0-	-0-	-0-
6.	Marine Midland Savings Account #530-68166-8	5,639.73	5,938.76	6,274.51	156.90
7.	Marine Midland Savings Certificate #P514-63426-0	-0-	2,000.00	2,000.00	2,000.00
8.	Marine Midland Savings Certificate #P514-71876-5	-0-	-0-	-0-	10,000.00
9.	Canandaigua Nat'l Bank & Trust Co. Savings Account #1-13529	229.30	239.78	251.96	264.78
10.	Canandaigua Nat'l Bank & Trust Co. Savings Account #1-10348	671.77	703.35	739.18	776.82
11.	Community Savings Bank Account #P-1436	3,534.22	960.74	14,375.45	8,243.14
12.	Community Savings Bank 7% Subordinated Note #Q467	5,000.00	5,000.00	5,000.00	5,000.00
13.	Community Savings Bank Account #413-0579	-0-	-0-	-0-	500.00
14.	Community Savings Bank Account #413-0580	-0-	-0-	-0-	500.00
15.	Community Savings Bank Account #413-0581	-0-	-0-	-0-	500.00
16.	Community Savings Bank Account #413-0582	-0-	-0-	-0-	500.00
17.	Community Savings Bank Account #413-0814	-0-	-0-	-0-	500.51
18.	Community Savings Bank Account #413-0815	-0-	-0-	-0-	500.51
19.	Columbia Banking Account #6-501214	8,160.73	-0-	-0-	-0-
20.	Columbia Banking Account #6-000008	4,958.82	696.85	1,152.20	1,722.45
21.	Columbia Banking Account #6-000558	1,221.08	2,326.88	2,434.09	44.21
22.	Columbia Banking Account #6-000559	1,221.08	2,326.88	2,454.09	44.21
23.	Columbia Banking Account #6-200818	-0-	-0-	-0-	3,706.02
24.	Columbia Banking Account #6-200819	-0-	-0-	-0-	3,706.37
25.	Haven Savings & Loan Ass'n Certificate #17-5785	-0-	-0-	-0-	-0-
26.	Home Federal Savings & Loan Ass'n of San Diego Account #10-121940-0	-0-	2,692.92	2,470.53	7,073.36
27.	Rochester Savings Bank Account #111-002-546	-0-	-0-	-0-	1,049.86
28.	Rochester Savings Bank Account #111-002-547	-0-	-0-	-0-	1,049.86
29.	Sheridan Savings & Loan Ass'n Account #02-007-00045	-0-	472.65	1,947.15	3,559.36
30.	Banco De Lordres Y. Mexico S.A. Account #38520229	-0-	-0-	-0-	10,000.00
31.	Bank of America Account #01790-02056	-0-	600.00	600.00	600.00
	CHECKS IN TRANSIT				
32.	Marine Midland Bank Official Check #0900232	-0-	-0-	6,000.00	-0-
33.	Marine Midland Bank Official Check #0900233	-0-	-0-	6,000.00	-0-
34.	Marine Midland Bank Official Check #3414632	-0-	-0-	-0-	5,000.00
35.	Marine Midland Bank Official Check #3414634	-0-	-0-	-0-	5,000.00
	LOANS RECEIVABLE				
36.	Anthony V. Cardulla, Jr.	5,400.00	10,100.00	5,100.00	3,300.00
37.	Mary Lou Scherbyn	-0-	3,527.35	2,052.85	5,440.64
38.	JoAnne Heck	-0-	-0-	-0-	-0-
39.	Richard J. Cardulla	-0-	-0-	-0-	-0-
40.	Douglas Lietz	-0-	-0-	500.00	500.00
41.	Hyb Jossem	-0-	-0-	500.00	500.00
	BUSINESS				
42.	Inventory	24,500.00	21,970.00	23,900.00	32,400.00
43.	Equipment	77,082.23	84,282.23	84,282.23	85,574.21
	SECURITIES				
44.	Agway Common Stock and 6% Debenture	250.00	250.00	250.00	250.00
45.	NEL Gross Fund, Inc.	519.80	531.17	544.22	548.70
46.	Eastman Kodak Stock	163.25	163.25	163.25	163.25
47.	U. S. Government, Series "E" Bond	1,500.00	-0-	-0-	-0-
48.	New York City Bond	-0-	10,100.60	10,100.60	10,100.60
		$206,771.36	$169,744.33	$199,192.47	$227,697.17
	REAL ESTATE				
49.	6560 Break of Day Road, Victor, New York	7,000.00	7,000.00	7,000.00	7,000.00
50.	Barns, Victor, New York	20,000.00	20,000.00	20,000.00	20,000.00
51.	Lots 4 & 5, Lehigh, Florida	3,410.00	3,410.00	3,410.00	3,410.00
52.	Maple Avenue, Victor, New York	14,000.00	14,000.00	14,000.00	14,000.00
53.	East Victor Road, Victor, New York	4,500.00	4,500.00	4,500.00	-0-

	ASSETS	12-31-72	12-31-73	12-31-74	12-31-75
54.	5050 West Point Loma Blvd., San Diego, California	-0-	114,000.00	114,000.00	114,000.00
55.	Warehouse, Maple Ave., Victor, New York	-0-	-0-	41,120.00	41,120.00
56.	Earlham St., Ramona, California	-0-	-0-	-0-	76,500.00
	IMPROVEMENTS TO RENTAL PROPERTY				
57.	Box Springs and Mattresses	-0-	880.00	880.00	880.00
58.	Carpeting	-0-	-0-	5,280.00	5,280.00
	TOTAL ASSETS	$255,681.36	$333,534.33	$409,382.47	$509,887.17
	LIABILITIES				
59.	Canandaigua Nat'l Bank, Note Payable	-0-	-0-	-0-	-0-
60.	Marine Midland Bank, Note Payable	5,000.00	-0-	-0-	-0-
61.	Home Federal Savings & Loan Ass'n Mortgage #151955	-0-	40,596.80	37,616.87	29,220.69
62.	Michael A. & Sharon R. Berstein Installment Note	-0-	-0-	-0-	52,372.91
	INVESTMENT IN CARDULLA SALES				
63.	Richard J. Cardulla	10,784.38	16,834.92	20,597.96	23,873.86
64.	JoAnne Heck	1,264.00	3,064.00	5,200.00	7,000.00
65.	Reserve for Depreciation	70,525.62	80,400.14	94,055.30	109,410.33
	TOTAL LIABILITIES	$ 87,574.00	$140,895.86	$157,470.13	$221,877.79
	TOTAL ASSETS	$255,681.36	$333,534.33	$409,382.47	$509,887.17
	TOTAL LIABILITIES	87,574.00	140,895.86	157,470.13	221,877.79
	NET WORTH	$168,107.36	$192,638.47	$251,912.34	$288,009.38
	PRIOR YEARS NET WORTH		168,107.36	192,638.47	251,912.34
	NET WORTH INCREASE		$ 24,531.11	$ 59,273.87	$ 36,097.04
	ADJUSTMENTS				
	ADDITIONS				
66.	Federal Income Taxes Paid		9,853.75	2,703.78	1,906.00
67.	State Income Taxes Paid		3,393.13	371.00	1,400.60
68.	Life Insurance Premiums Paid		3,495.29	80.95	80.95
69.	1974 Fiat Gift to Richard J. Cardulla		-0-	3,650.00	-0-
70.	1975 Mercedes Benz		-0-	-0-	9,800.00
71.	Gifts to Scherbyne		400.00	400.00	400.00
72.	Gift to Jennie DeNicola		5,000.00	-0-	-0-
73.	Gift to Anthony V. Cardulla, Jr., East Victor Rd., New York		-0-	-0-	4,500.00
74.	Living Expenses by Check		1,632.93	6,939.65	2,531.74
75.	Cash Living Expenses		1,560.00	1,560.00	1,560.00
	ELIMINATIONS				
76.	Federal Income Tax Refunds		(625.98)	(167.68)	-0-
77.	Dividend Exclusion (NEL & AGWAY)		(1.50)	(1.75)	(2.00)
78.	Nontaxable New York City Bond Interest		(525.00)	(525.00)	(525.00)
	CORRECTED ADJUSTED GROSS INCOME		$ 48,713.73	$ 74,284.82	$ 57,749.33
79.	Itemized Deductions Corrected		(5,488.06)	(2,997.32)	(3,523.10)
80.	Exemptions		(1,500.00)	(1,500.00)	(1,500.00)
	CORRECTED TAXABLE INCOME		$ 41,725.67	($ 69,787.50)	$ 52,726.23)
81.	Taxable Income Reported		(8,512.00)	(11,934.00)	(4,184.00)
	UNREPORTED TAXABLE INCOME		$ 33,213.67	$ 57,853.50	$ 48,542.23

OPINION

The first issue for decision is whether the Cardullas are liable for the deficiencies in Federal income tax for the taxable years 1973, 1974, and 1975. A presumption of correctness attaches to respondent's determination, and petitioners bear the burden of overcoming this presumption and proving his determination to be erroneous. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

In the instant case, decedent failed to maintain a complete and adequate set of books and records with regard to their income producing activities during the taxable years in issue as required by section 6001.[4] See section 1.6001-1(a), Income Tax Regs. The amounts of the Cardullas' gross income, deductions and other items required to be shown on their Federal income tax returns for each of the years in issue could not be determined from the information submitted to respondent for examination. Under such circumstances, the Commissioner is authorized by section 446 to reconstruct the taxpayer's income by applying a method that will, in his opinion, clearly reflect income. Section 446(b); see Holland v. United States, 348 U.S. 121, 130-

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[4] Sec. 6001 provides in pertinent part as follows:

> Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. * * *

132 (1954); Campbell v. Guetersloh, 287 F.2d 878, 880 (5th Cir. 1961); Davis v. Commissioner, 239 F.2d 187, 189 (7th Cir. 1956), affg. a Memorandum Opinion of this Court. The "net worth" method used by respondent in the instant case to reconstruct the Cardullas' income for the three years in issue has long been recognized by this Court as an acceptable method of reconstructing income. Holland v. United States, supra; Cefalu v. Commissioner, 276 F.2d 122 (5th Cir. 1960), affg. a Memorandum Opinion of this Court; Davis v. Commissioner, supra; Lipsitz v. Commissioner, 21 T.C. 917 (1954), affd. 220 F.2d 871 (4th Cir. 1955).

Petitioners allege that Revenue Agent Zingaro testified that the Cardullas did in fact maintain a set of books reflecting the transactions occurring in their business during the period in question. In this regard, petitioners argue that the existence of these books makes respondent's use of the net worth method inappropriate.[5] We disagree. Revenue Agent Zingaro was confused by petitioners' questions at trial and his answers erroneously implied that Mr. Cardulla kept a set of books and records detailing his business transactions. Later, Mr. Zingaro clarified for the Court that the "books and records" to which he referred when questioned by petitioners' attorney consisted merely of Mr. Cardulla's checking and savings account statements and various spread sheets prepared by petitioners' accountant. We were not at all mislead by Mr. Zingaro's testimony.

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[5] It should be noted that, despite petitioners' admonitions to the contrary, the use of the net worth method is not restricted to use in cases in which the taxpayer does not maintain any books and records. Holland v. United States, 348 U.S. 121, 131 (1954).

Although many, and indeed most, of the figures used by respondent to compute the Cardullas' net worth were stipulated, petitioners have made certain challenges to the accuracy of respondent's deficiency determinations. Petitioners bear the burden of establishing the necessity of any adjustments to respondent's determinations. Furthermore, should petitioners succeed in proving that certain of respondent's computations were erroneous, this will not vitiate the use of the net worth method by respondent, and the presumption of correctness will continue to attach to the remainder of his deficiency determination. *Marcello v. Commissioner*, 380 F.2d 494, 497 (5th Cir. 1967), affg. a Memorandum Opinion of this Court; *Cefalu v. Commissioner, supra* at 125; *Harper v. Commissioner*, 54 T.C. 1121, 1129 (1970).

The premise underlying the net worth method of reconstructing income is that a taxpayer uses his taxable income to make both deductible and nondeductible expenditures and to purchase assets. The net worth theory is based on the proposition that if the increase in a taxpayer's net worth during a specific year *plus* his nondeductible expenditures for that period, exceed his reported net income for the year, this excess will constitute unreported taxable income. See generally, 2 Mertens, Law of Federal Income Taxation, sec. 12.112, p. 453 (Rev. 1985).

The first step in the net worth reconstruction of income is to accurately determine an opening net worth by competent evidence. After an opening net worth has been determined, respondent must attempt to ascertain the amount of any increase in net worth from year to year. The mere fact of an increase in net worth, however, is not the equivalent of taxable income. The taxpayer may have made nondeductible expenditures (i.e., for daily living expenses) which, in the absence of an appropriate modification, would result in the net worth increase being less than the taxpayer's actual taxable income for the period in question. Alternatively, the taxpayer may have acquired assets during the course of the year from income which is partially or wholly exempt from taxation (i.e., gifts, municipal bond interest, and capital gains). Once again, without the necessary adjustment, the net worth increase would be greater than the actual amount of the taxpayer's taxable income. Thus, the increase in net worth for the period is first determined by comparing net worth (assets over liabilities) for the year in question with that of the prior year.[6] Then the increase in the taxpayer's net worth must be adjusted as follows:

(1) Expenditures for nondeductible items are added to the increase in net worth. Typically such nondeductible expenditures include the taxpayer's personal living expenses.

(2) The nondeductible portion of capital losses and those nondeductible losses sustained in the disposition of personal assets are also added to the net worth increase. A nondeductible loss would otherwise have a downward effect on the net worth increase thereby incorrectly reducing taxable income.

(3) The net worth increase must be decreased by the total of any nontaxable income received during the period in question (i.e., gifts, inheritances, tax-exempt interest, etc.). Without such an adjustment, the taxpayer's net worth increase would be overstated resulting in his taxable income being artificially inflated. 2 Mertens, supra at sec. 12.113.[7]

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[6] The net worth method is not a computation based on the fair market value of assets, but instead is made in terms of the cost basis of the underlying assets. This is due to the fact that regardless of the method used to calculate income, fluctuations in the value of an asset are not taken into a taxpayer's income stream until realized. 2 Mertens, Law of Federal Income Taxation, sec. 12.113, p. 463 (Rev. 1985).

[7] Net operating loss carryovers and capital loss deductions also have the effect of reducing the net worth increase to arrive at adjusted taxable income.

The increase in net worth for a given year, as adjusted, is the taxpayer's adjusted gross income for that particular taxable year. The taxpayer's deductions and exemptions for that year are then subtracted from adjusted gross income to arrive at taxable income. To determine the actual amount of the deficiency, the taxable income amount, as determined above, is reduced by the amount of taxable income actually reported by the taxpayer on his return for the years in question. 2 Mertens, supra at sec. 12.113.

Bank Accounts

Petitioners first attack on the Commissioner's computations is their assertion that certain of the 28 bank accounts listed on the net worth and personal expenditures statement do not belong to petitioners and, therefore, should not be included as petitioners' assets. The bank accounts at issue are of two types. The first is a Marine Midland Bank savings certificate (#P514-71876-5), which Mr. Cardulla held jointly with his son, Anthony Cardulla, Jr., and on which an assignment for a surety bond was placed. The second type of bank account consists of 12 savings accounts at Community Savings Bank, Columbia Banking, and Rochester Savings Bank. Petitioners allege that this later group of bank accounts were held in trust for the Cardullas' grandchildren and, therefore, should not be treated as assets on respondent's net worth statement.

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The evidence presented at trial indicates that the Marine Midland account was a certificate of deposit maintained by decedent Anthony Cardulla and his son Anthony, Jr. The source of the $10,000 used by decedent to purchase the certificate of deposit was a November 1975 withdrawal from Marine Midland Savings account #530-68166-8, which was an escrow account maintained solely by decedent. Attached to the certificate of deposit is a document assigning "all moneys due or to become due" from the certificate to the Security Insurance Company of Hartford. Respondent included the certificate of deposit in petitioners' net worth because the money used to purchase it came directly from one of decedent's savings accounts.

Petitioners have the burden of proof with respect to establishing that the amounts reflected in both the escrow account and the certificate of deposit were erroneously reported on the net worth and personal expenditures statement. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933). Petitioners, in the instant case, have failed to introduce any evidence to impugn the propriety of including these amounts as assets on the net worth statement. Furthermore, although the amounts in question appear to be related to a performance bond required by the Erie Lackawanna Railroad, the money was still in the account as of the close of the period in question. Thus, although the assets in question were apparently subject to forfeiture if Mr. Cardulla failed to adequately discharge his performance obligations to the railroad, no such forfeiture occurred and the assets remained in Mr. Cardulla's account. In addition, the fact that the certificate of deposit was in the name of both Mr. Cardulla and his son Anthony, Jr. does not change the result. Petitioners failed to produce any evidence to suggest that Anthony Cardulla's rights to the certificate of deposit were in any way subordinate to or qualified by his son's interest in the account. Indeed, Anthony Cardulla, Jr. made no statement nor other allegation, during his testimony at trial, that any of the funds placed in the account were his. As discussed infra, the $10,000 actually used to purchase the certificate of deposit came directly from one of Mr. Cardulla's bank accounts. We believe that respondent was correct in including the certificate of deposit in petitioners' net worth.

Petitioners also questioned the inclusion by respondent in the net worth computation of certain savings accounts at Community Savings Bank, Columbia Banking, and Rochester Savings Bank. The moneys in these accounts were held by the Cardullas in custodial accounts for their grandchildren. The parties agreed that the following bank accounts were custodial accounts established with either Mary or Anthony Cardulla as custodian for their grandchildren pursuant to the New York Uniform Gifts to Minors Act:

	Name of Bank	Account Number
1.	Community Savings	413-0579
2.	Community Savings	413-0580
3.	Community Savings	413-0581
4.	Community Savings	413-0582
5.	Community Savings	413-0814
6.	Community Savings	413-0815
7.	Columbia Banking	6-000558
8.	Columbia Banking	6-000559
9.	Columbia Banking	6-200818
10.	Columbia Banking	6-200819
11.	Rochester Savings	111-002-546
12.	Rochester Savings	111-002-547

Respondent contends that these accounts should be included in petitioners' net worth because of the control that the Cardullas allegedly maintained over these accounts. As to certain of these accounts, Mr. Cardulla signed the signature cards so that he could presumably withdraw funds from the account. Such a withdrawal, however, would be solely in his capacity as a custodian and not as the beneficial owner of the funds. We find respondent's argument to be misplaced in light of the rigid statutory guidelines established for these custodial accounts by the New York Uniform Gifts to Minors Act. A gift made pursuant to the Act is irrevocable and conveys to the minor indefeasibly vested legal title to the property in question. N.Y. Estates, Powers and Trusts Law, section 7-4.3 (McKinney 1984) (hereafter "EPTL").

The Uniform Gifts to Minors Act was enacted in New York to provide an alternative for people who wished to make gifts to their young progeny without placing the gifted property directly into the hands of the unwitting minor. The statute provides the custodian with broad powers to accumulate or expend income or principal. A transfer made pursuant to the Uniform Gifts to Minors Act qualifies the donor for the annual gift exclusion pursuant to section 2503. Furthermore, the custodianship is ignored for Federal income tax purposes. Thus, the custodian is not required to file income tax returns because the minor reports the income from the custodianship property.[8] The Act provides for the mandatory distribution of the property to the minor upon the donee's attaining majority age. EPTL section 7-4.4(d) (McKinney 1984).

We find that petitioners have sustained their burden of proving that respondent improperly included these custodial accounts in the Cardullas' net worth. As noted above, the parties have agreed that these bank accounts were established pursuant to the Uniform Gifts to Minors Act in New York. As such, these accounts can properly be categorized as "fiduciary" or "trust" accounts. Accordingly, the funds in these accounts do not constitute assets belonging to the Cardullas and, therefore, these funds should not be included in their opening and closing net worth for the taxable years in question.[9] We note, however, that the actual deposits made to these custodial accounts should be treated as gifts in the years the deposits were made. As discussed above, a taxpayer's net worth is determined as of the end of a given taxable year. The increase in net worth is then adjusted by adding to it certain nondeductible expenditures such as the deposits, or gifts, made to these custodial accounts. Thus, the cash deposits made to these Uniform Gifts to Minors Act accounts will necessitate an upward adjustment in the net worth increase for the particular year in which the deposit was made. The deposits to these accounts will simply be listed as gifts to grandchildren under the title of "Adjustments" on petitioners' net worth and personal expenditures statement, rather than as "Cash in Banks" in the asset column.

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[8] If, however, the income from the custodianship property is used for the child's support, that income is reportable by the person having the legal obligation of support. Rev. Rul. 56-484, 1956-2 C.B 23; Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 70-348, 1970-2 C.B. 193.

New York City Bond

Petitioners next allege that they erroneously admitted that they held a $10,000 New York City Bond during the years 1973 through 1975. Respondent argues that the Cardullas did in fact hold the bond during the years in issue and that he relied on their admission and, therefore, did not present any additional evidence at trial. According to respondent, petitioners should be estopped from now withdrawing their admission. We agree with respondent.

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[9] See Peppers v. Commissioner, T.C. Memo. 1981-728.

Petitioners also argue that they erred in admitting ownership of the New York City Bond because the evidence indicates that the bond was paid on January 23, 1973. The evidence that petitioners refer to consists of a copy of the bond itself having stamped on its face "Paid JAN 23, 1973." The Cardullas now contend that the stamp signifies that the amount of the bond was paid to them on January 23, 1973 and, therefore, that the bond should not appear as an asset on petitioners' net worth statement for the years in issue. Respondent argues that petitioners' interpretation of the "paid" stamp is erroneous. We agree with respondent.

The face of the bond clearly shows a "trade date" (upper right hand corner) of January 16, 1973. This represents the date that the bond was ordered. According to respondent, it is common practice in the trading of securities to allow seven days for the payment of the bond purchase price. This date constitutes the "settlement date" located in the middle of the right hand side of the bond. The purchaser is required to pay the broker the purchase price of the bond prior to the settlement date. The lower portion of the bond shows that the Cardullas delivered a check to Marine Midland Bank in Pittsford, New York, on January 23, 1973, and the bond was accordingly stamped as "paid" on that date. We note that the maturity date on this bond was July 1, 1987. We find respondent's description of this transaction to be quite plausible.

Petitioners have failed to provide this Court with any evidence to support their assertion that the bond was redeemed in 1973. This we find unacceptable in light of their burden of proof on this issue. Rule 142(a). We note that any questions concerning this bond could readily have been addressed to Mr. John Nagurney. Mr. Nagurney was called by respondent to testify on behalf of the Marine Midland Bank regarding other checks which petitioners had not admitted to during the discovery process. His rather lengthy testimony was taken on August 2, 1983, the first day of this trial. At the close of his testimony, Mr. Cardulla stated he had no further questions of the witness, and he was excused by the Court. Inasmuch as the New York City Bond was purchased through Marine Midland Bank, Mr. Nagurney could have readily described the bank's procedures regarding settlement dates and the "paid" stamp on the face of the bond. Instead, petitioners' counsel raised the question for the first time late in the second day of trial. We find petitioners' allegation that the bond was in fact paid in 1973, rather than purchased in 1973, to be totally without evidentiary support.

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Furthermore, petitioners forfeited their right to question the inclusion of this asset in respondent's net worth computation by admitting that they held the bond during the years in issue in Respondent's Requests for Admissions. Rule 90(e) provides in pertinent part as follows:

> (e) Effect of Admission: Any matter admitted under this Rule is conclusively established unless the Court on motion permits withdrawal or modification of the admission. * * *

This Court has consistently held that a party has the right to rely on the responses to a request for admissions. Rule 90; Freedson v. Commissioner, 65 T.C. 333 (1975), affd. 565 F.2d 954 (5th Cir. 1978). A copy of the bond in question was attached to Respondent's Requests for Admissions and was duly moved and accepted into evidence by this Court during the August 1983 trial of the instant case. It should be noted that this Court has long recognized that a party must admit or deny a specific request for admission based on the information and evidence at his disposal at the time he answers the request. "Obviously, as a case progresses, new evidence or further thought might require such party to raise additional legal or factual contentions." Estate of Allensworth v. Commissioner, 66 T.C. 33, 40 (1976). Rule 90(e) specifically provides for the modification or withdrawal of admissions by leave of this Court. If a party requests such permission, we would at that time decide whether the request is timely and consider the consequences of allowing petitioners to change their position.

In the instant case, the document in issue was attached to Respondent's Requests for Admission. Furthermore, respondent brought all of the documents supporting these requests to Washington, D.C., on December 8, 1982, at which time petitioners' attorney had ample opportunity to review them in detail. Thus, with respect to the admission in issue, petitioners had all of the information and evidence in their possession at the time they admitted that they held the bond during all of the years in issue. Furthermore, petitioners never made a motion in this Court to withdraw the admission. For the reasons stated above, we refuse to grant petitioners' belated request to deny their earlier admission.

Inventory

Petitioners next assert that the approach taken by respondent to value inventory for purposes of the net worth computation was improper.[10] Both petitioners and their Schedule

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[10] We note that petitioners also make the argument that respondent erroneously failed to account for transportation and storage expenses in determining inventory values. Petitioners' assertion in this regard is unfounded. Clearly, any out-of-pocket expenditures associated with transporting or warehousing the inventory items would have resulted in a reduction in the specific asset line that was diminished by the expenditure (e.g., "cash on hand"). Furthermore, respondent allowed for a reduction in the net worth increase to reflect petitioners' itemized deductions. Presumably, such business expenses would have been reflected as itemized Schedule C deductions. Petitioners have not presented this Court with any evidence as to the precise amount of expenses associated with the transportation and storage of inventory, nor did petitioners establish that such expenses were not already properly accounted for on the net worth statement.

C business Cardulla Sales, were cash basis taxpayers during the years in issue. The Cardullas' Federal income tax returns for the taxable years 1969, 1970, and 1971 were previously audited by the Internal Revenue Service. As a direct result of that particular audit, decedent altered the method that he had used to report his inventory values on his tax returns. Prior to the audit, petitioners calculated the value of their inventory by including both the value of merchandise actually paid for and any accounts payable on the items purchased from the railroads that were still unpaid at year end. Following the audit for the years 1969, 1970, and 1971, Mr. Cardulla was advised by his accountant that, because he reported his income on the cash basis, he should report only the value of that inventory which had actually been paid for.

Mr. Cardulla explained to respondent during a 1976 interview that, during the years following the audit, he would make a physical count of all the merchandise on hand at the end of each year. The inventory, according to Mr. Cardulla, was then valued at the lesser of cost (amount paid) or fair market value. The inventory values used by respondent in his net worth computation for each of the taxable years in issue were taken directly from the Cardullas' 1972, 1973, 1974, and 1975 Federal income tax returns. The revenue agent reviewed the decedent's cancelled checks and determined that these amounts corresponded with the inventory values reported by the Cardullas.

Petitioners cite Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), for the proposition that respondent improperly required the Cardullas to "write-down" their inventory. Petitioners contend that the prior audit adjustment discussed above, requiring Mr. Cardulla to reduce his inventory by the corresponding accounts payable, is somehow offensive. Petitioners' assertion is difficult to comprehend in light of the fact that the Cardullas had always reported their income on the cash basis and the prior audit merely placed petitioners' method of valuing inventory on the cash basis as well. In Thor Power Tool Co. v. Commissioner, supra, the taxpayer reduced the value of a portion of its inventory based on its estimate that some of its merchandise was no longer marketable. The merchandise in question was reduced to either "scrap value" or "spare parts" value, both of which were substantially less than fair market value. Thor Power Tool Company, however, continued to hold the items in its inventory for sale at their original fair market value prices. The taxpayer's annual reduction in inventory values was disallowed because, according to the Commissioner, there was no basis for an annual reduction in inventory value unless (1) the taxpayer actually offered the merchandise at the lower price in its ordinary course of business (i.e., a year-end sale); or (2) the merchandise was actually physically defective. This Court, the Seventh Circuit Court of Appeals, and the United States Supreme Court all agreed with the Commissioner. "In construing section 446 and its predecessors, the Court has held that '[t]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income.'" Thor Power Tool Co. v. Commissioner, supra at 532.

The method used by the taxpayer to "write-down" its inventory in Thor is quite unlike the method used by respondent to determine petitioners' inventory values for purposes of his net worth calculation. We find petitioners' reliance on Thor Power Tool to be erroneous. Respondent's discretion in changing petitioners' method of reporting inventory during the prior audit was well within his discretion because it merely placed petitioners on a system of valuing their inventory that was consistent with their cash method of reporting income. Furthermore, as respondent correctly points out, the very nature of a net worth reconstruction precludes the prior audit from having any impact on the years in issue in the instant case as the first year involved herein is 1973, a full two years after the final year of the earlier audit. As such, the year in between the audit and the first year in issue (1972) would cure any transitional inconsistencies caused by the prior audit adjustment.

Although not entirely evident from petitioners' brief, it appears as though the Cardullas believe that respondent should have valued their inventory on an accrual basis for purposes of the net worth computation. We disagree. As discussed above, the method utilized by respondent to value petitioners' inventory is entirely consistent with the Cardullas' cash basis method of reporting income. In Vassallo v. Commissioner, 23 T.C. 656 (1955), the taxpayers who filed their tax returns on the cash basis, argued that it was improper for respondent to use a cash basis net worth reconstruction because they had inventories. In response to their objection, we said:

> The comparative net worth method of determining income and the sources and expenditures method, used by respondent in determining Vassallo's income, are not systems of accounting. Those methods are resorted to, as they were here, only because a taxpayer's books and records do not disclose his true income, nor is it possible to determine from such books and records what that income was. While we agree with petitioners that the respondent's reconstruction of Vassallo's income by such methods would have been more exact had its actual inventories been included, the respondent, under the authority granted him in section 41 of the Code, determined such income on the cash basis--the method which, in his opinion, most clearly reflected it. It was incumbent on the petitioners to show the amount of the inventories which they argue, if used, would more correctly reflect income. They made no such showing and we, therefore, approve the respondent's determination. [Vassallo v. Commissioner, supra at 661-662. Citations omitted.][11]

Respondent utilized a cash basis net worth computation using those inventory values reported by petitioners on their Federal income tax returns for the years in issue. Respondent was subsequently able to determine that the amounts on petitioners' cancelled checks corresponded with the values reported by the Cardullas on their tax returns for each of the years in issue. As a result, we do not believe that the use of an accrual basis net worth statement would have more clearly reflected income than the method which respondent chose to use.[12] Furthermore, if we were to allow the liability component of petitioners' net worth statement to include the trade payables corresponding to the decedent's inventory, there would of necessity be a correlating increase in the inventory value in the asset section. In effect, the upward adjustments to both the asset and liability components of petitioners' net worth computation would net out and, thus, have no effect on the overall amount of the net worth increase from year to year. Thus, the change suggested by petitioners would have no impact on the amount of the deficiencies as determined by respondent for the years in issue.[13]

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[11] See Kofmehl v. Commissioner, T.C. Memo. 1978-439.

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[12] We also note that even if petitioners had reported their income on the accrual basis, respondent would not be precluded from reporting the Cardulla's inventory values on the cash basis for purposes of the net worth computation. The bellweather case in this area is Holland v. United States, 348 U.S. 121 (1954), wherein the taxpayers argued that the net worth method could not be used because it was a method of accounting different from that which they had been using. The Court stated therein:

> The provision that the "net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer," refers to methods such as the cash receipts or the accrual method, which allocate income and expenses between years. The net worth technique, as used in this case, is not a method of accounting different from the one employed by defendants. It is not a method of accounting at all, except insofar as it calls upon taxpayers to account for their unexplained income. * * * [Holland v. United States, supra at 131.]

We conclude that respondent's treatment of petitioners' inventory for purposes of the net worth reconstruction of income was proper. The Cardullas were cash basis taxpayers and the inventory values reported on their tax returns properly reflected only that merchandise that petitioners had paid for. Furthermore, even if the method used by the Government to report inventory for purposes of the net worth computation is less precise than it might otherwise have been, it is clear that petitioners have failed to sustain their burden of proving what the actual inventory figures are or how much of the corrected inventory was encumbered by accounts payable. The burden of showing that respondent's method was not accurate, as well as providing a more accurate method of computing inventory, clearly falls on petitioners. Rule 142(a); Vasallo v. Commissioner, 23 T.C. at 662. See also United States v. Cramer, 447 F.2d 210, 217 (2d Cir. 1971).[14]

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[13] We note that if, following the purchase of a particular item of inventory, its fair market value fell below its "cost" before it was sold and before the corresponding account payable was paid, the adjustments made to the liability and asset columns of petitioners' net worth statement would not exactly offset one another. We doubt, however, that this would have occurred during the years in issue in light of the fact that generally, petitioners' accounts payable were paid within approximately 3 months of the purchase of the corresponding item of inventory.

We further believe that respondent utilized a method known to reflect income clearly. Petitioners are hardly in a position to complain when respondent has merely adopted both the income reporting method used by petitioners and the figures actually reported by the Cardullas on their 1972, 1973, 1974, and 1975 income tax returns. These values constitute effective admissions which petitioners are bound by in the absence of credible evidence to the contrary.[15]

On a related matter, petitioners allege that respondent should reduce their inventory values by the value of certain inventory bartered or traded for carpeting, which was installed in their California apartment building. We find this argument to be totally without merit.

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[14] The only evidence relating to petitioners' outstanding trade payables was the testimony given by Alfred Wago, Freight Claims Manager for the Lehigh Valley Railroad. Mr. Wago testified that it was generally three months before the railroad was paid by Mr. Cardulla for the merchandise purchased by Cardulla Sales for resale. According to Mr. Wago, Cardulla Sales paid Lehigh Valley Railroad between $20,000 and $40,000 during each of the taxable years in issue. Petitioners did attempt to show that train derailments, and therefore payments to the railroads, fluctuated during the year (e.g., more during the winter months). Petitioners, however, made no showing that there was any substantial fluctuations from year to year.

[15] See Estate of Laity v. Commissioner, T.C. Memo. 1955-176.

The net worth method of reconstructing a taxpayer's income is similar to a photograph in the sense that it attempts to provide a delineation of that taxpayer's assets and liabilities as of a moment in time (e.g., December 31st of any year). Holland v. United States, 348 U.S. 121 (1954). The bartering of the inventory for the carpeting occurred during the 1974 taxable year and its effect would, therefore, have already been reflected in the year-end inventory value for purposes of the net worth computation. Indeed, Mr. Cardulla said himself that he took a physical count of all his existing inventory at the end of each year. Thus, the exchange was presumably reflected in the 1974 inventory figure reported by Mr. Cardulla on his income tax return for that year. Furthermore, petitioners are raising this argument for the first time on brief. Respondent was not made aware of the bartering until Anthony Cardulla, Jr. testified at trial. Thus, respondent was unable to confirm that the December 31, 1974 inventory figure did not include the value of the items allegedly traded. The fact that the inventory figure used by respondent for 1974 was Mr. Cardulla's own creates a strong inference that it did not. In any event, petitioners have presented no evidence to support their assertion that the bartered inventory was erroneously reported on the net worth statement for 1974 and, therefore, we sustain respondent's determination as to this issue. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

Cash on Hand

Petitioners contend that respondent erred in their net worth computation by including $13,806.40 in cash on hand at the close of the 1975 taxable year. The cash was used by Mr. Cardulla to pay expenses that petitioners incurred in his business as a salvage agent for two railroads. According to petitioners, the amount was entirely depleted by the close of the 1975 taxable year when the Cardullas' business was in the process of winding down. The evidence in the record, however, suggests otherwise.

We find there to be a substantial amount of evidence to refute petitioners' assertion that the $13,806.40 in cash on hand was depleted as of December 31, 1975: (1) the Cardulla's Schedule C inventory, as reported by them on their 1975 tax return, indicates an increase from the previous taxable year which is clearly not indicative of a business in the process of winding down; (2) Exhibit AW consists of a notice of auction which sets as an auction date August 28, 1976, and not the close of 1975; (3) petitioners' 1976 tax return still evidences substantial gross receipts and cost of goods sold for the 1976 taxable year. Indeed, the revenue agent and the special agent both visited the Cardulla's place of business in the later part of 1975 and early 1976 and found it to be very much an ongoing business; (4) petitioners' son Anthony Cardulla, Jr. testified that his father's business was involved in salvaging a large train derailment in Leroy, New York in early 1976; (5) finally,

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Mr. Cardulla himself told respondent's investigators that the $13,806.40 in cash on hand remained fairly constant until his business terminated its operations in the middle of 1976.

We believe that the Commissioner correctly reported petitioners' cash on hand on the net worth statement and we sustain respondent's determination on this issue.

Opening Net Worth

Petitioners argue that because respondent refused to include accounts payable when calculating inventory, an accurate opening net worth could not be established. We find these allegations to be without merit.

The first step taken under the net worth method is to accurately and clearly determine an opening net worth by competent evidence. According to the Supreme Court:

> [A]n essential condition in [net worth cases] is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion in this sum of all assets on hand at the outset. * * * [Holland v. United States, 348 U.S. 121, 132 (1954).]

After careful consideration of the record as a whole, we are convinced that, with respect to the taxable years in issue, respondent has satisfied this "essential condition."

As discussed above, petitioners' argument that respondent erroneously valued the Cardulla's inventory for purposes of the net worth computation is entirely unfounded. As discussed above, the exclusion of accounts payable from the inventory values reported on the net worth statement was entirely compatible with petitioners' cash method of reporting income. Furthermore, the inventory values used by respondent were those actually reported by petitioners on their tax returns for the years in issue.

We further disagree with petitioners' contention that respondent's purported failure to procure the railroads' records of Mr. Cardulla's accounts payable precluded an accurate opening net worth. In Holland v. United States, supra, the Supreme Court required the Government to "track down relevant leads furnished by the taxpayer--leads reasonably susceptible of being checked, which, if true, would establish the taxpayer's innocence." Holland v. United States, supra at 135-136. Since the only inventory included in the asset column of the net worth reconstruction was that inventory already paid for by petitioners, the existence of accounts payable related to merchandise purchased from the railroads would have no effect on the computation. Indeed, as discussed above, any additional liability amount, in the form of accounts payable to the railroads, would necessitate a corresponding increase in the inventory asset line on petitioners' net worth statement. The two adjustments would effectively offset one another and the "lead" which respondent allegedly failed to investigate would not have the effect of establishing petitioners' position. See note 12, supra.

A net worth reconstruction of income is a very protracted, and exhaustive procedure involving a great deal of the Government's time and resources. It is, therefore, not surprising that the Supreme Court would limit the leads which respondent is required to investigate to those that would actually have the effect of establishing petitioners' position. In the instant case, respondent methodically and thoroughly reviewed all of petitioners' bank records, canceled checks, surrogate court records, and real estate holdings in three different states. Numerous witnesses were contacted and interviewed. Every lead which would have shed light on petitioners' income or expenses was investigated.

Instead of reporting their income accurately as required by law, petitioners have erected hurdles and established obstacles to thwart respondent's efforts to properly compute their tax liability. We believe that the record as a whole establishes that the Commissioner did establish, with reasonable certainty, an opening net worth. We, therefore, find in favor of respondent on this issue.[16]

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[16] Petitioners also argued that respondent's failure to determine their accounts payable is particularly offensive because, according to petitioners, respondent knew of their existence through a prior audit. In addition, petitioners assert that inasmuch as the account payable records were lost or destroyed during the Federal consolidation of the railroads, respondent, also a Federal agency, should have taken action to preserve petitioners' defense. In light of our discussion above, we find both of these allegations to be totally without merit. We further note that petitioners have presented no evidence to sustain their burden of proving respondent's opening net worth to

(footnote continued)

Depreciation

Petitioners argue on brief that respondent did not allow for an adequate depreciation allowance on their California apartment complex, and that respondent erroneously disallowed a depreciation allowance on a 1975 Mercedes Benz owned by petitioners. Petitioners contend that considering the location of the apartment building and its construction, a useful life of 15 years and a double declining method of depreciation should have been used. We disagree. The taxpayer bears the burden of proving their entitlement to claimed deductions. Deputy v. duPont, 308 U.S. 488 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Respondent allowed petitioners 7/12's of the normal straight line depreciation allowance because the apartment complex was purchased in May of 1973. We note that generally the taxpayer can elect a method of depreciation on his tax return. In the instant case, however, petitioners failed to report the rental income from the California apartment building and did not claim any depreciation allowance whatsoever. Petitioners' unsupported assertions that a more appropriate method of depreciation should have been adopted by respondent for purposes of the net worth computation are not sufficient to satisfy their burden of proving

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(footnote continued from previous page)
be erroneous. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

respondent's determination to be erroneous. Marcello v. Commissioner, 380 F.2d 494, 497 (5th Cir. 1967), affg. a Memorandum Opinion of this Court; Cefalu v. Commissioner, 276 F.2d 122, 125 (5th Cir. 1960), affg. a Memorandum Opinion of this Court; Harper v. Commissioner, 54 T.C. 1121, 1129 (1970). We therefore find for respondent on this issue.

Petitioners' son Anthony Cardulla, Jr. testified that his father used their Mercedes Benz in 1975 to travel to and from the various train derailments because the car used diesel fuel and was, therefore, easier to refuel late at night. Although it is clear that the car was used in part for business purposes, petitioners failed to provide evidence as to the exact extent that the car was used for non-business purposes. Resolving these uncertainties against petitioners, whose inexactitude is of their own making, we hold that petitioners are entitled to deduct only 50 percent of the otherwise allowable depreciation deduction. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Petitioners' will qualify for a depreciation allowance for purposes of the net worth computation only to this extent.

Addition to Tax--Fraud

The next issue for decision is whether Mr. Cardulla is liable for the addition to tax for fraud for the three taxable years in issue.

Section 6653(b) provides, in part, that "[i]f any part of any underpayment * * * of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to

50 percent of the underpayment." Thus, the addition to tax under section 6653(b) presumes the existence of an "underpayment."[17] In the absence of such an underpayment, there is nothing upon which the fraud addition to tax would attach. Jenkins v. United States, 313 F.2d 624, 627 (5th Cir. 1963).[18] Therefore, affirmative proof of an underpayment is a necessary element of the Commissioner's burden of proof. To prove an underpayment, respondent is not required to establish the precise amount of the deficiency determined by him. However, the Commissioner cannot satisfy his burden by relying solely on petitioners' failure to discharge their burden of proving error in his determination of the deficiency. Otsuki v. Commissioner, 53 T.C. 96, 106 (1969); Pigman v. Commissioner, 31 T.C. 356, 370 (1958). Pursuant to the terms of section 6653(b), the fraud addition to tax attaches to the entire underpayment even though only a portion of it is actually attributable to the fraud. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964), affg. 37 T.C. 703 (1962); Breman v. Commissioner, 66 T.C. 61 (1976); Stewart v. Commissioner, 66 T.C. 54 (1976).

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[17] The term "underpayment" is defined in sec. 6653(c) in essentially the same manner as a "deficiency" to mean the amount by which the tax imposed exceeds the amount of tax shown by the taxpayer on his return. Sec. 6211.

[18] See also Compton v. Commissioner, T.C. Memo. 1983-642.

Respondent determined the underpayment in the instant case by using the net worth method of reconstructing petitioners' income. We believe that the Commissioner's net worth analysis is sufficient to sustain his burden of proof as to the existence of an underpayment. The net worth method is an acceptable mechanism for testing the accurateness of the deficiency, but its use requires "the exercise of great care and restraint" on the part of respondent. Holland v. United States, 348 U.S. at 129. As discussed above, the Supreme Court in Holland held that in order for the Commissioner to validate his assertion that increases in net worth are due to unreported taxable income, respondent must establish with reasonable certainty, an opening net worth and he must establish that the annual increases in net worth emanated from taxable sources of income:

> Increases in net worth, standing alone, cannot be assumed to be attributable to currently taxable income. But proof of a likely source, from which the jury could reasonably find that the net worth increases sprang, is sufficient. * * * [Holland v. United States, supra at 137-138.]

The Supreme Court subsequently held in United States v. Massei, 355 U.S. 595 (1958), that such proof of a likely source of the net worth increase was not mandatory and that negating all possible sources of nontaxable income would be sufficient. The Holland and Massei decisions, therefore, impose the requirement that the Government prove a likely source of taxable income, or, conduct an investigation of leads reasonably susceptible of being checked which, if true, would establish petitioner's innocence of fraud.[19]

Respondent's determination of petitioners' net worth in the instant case was predicated on certain information obtained by respondent's agents during the course of their investigation. Many interviews were conducted with petitioners and numerous other persons were contacted to enable respondent to substantiate the data that was gathered. Respondent provided this Court with detailed documentation to corroborate each item that was included on the Government's net worth statement. Indeed, only six items on the net worth statement were still in contention when the instant case went to trial. As discussed above, all of the contested items, with the exception of the custodial accounts established pursuant to the Uniform Gifts to Minors Act and the depreciation allowance relating to petitioner's Mercedes Benz, were resolved in respondent's favor.

We believe that respondent has reasonably established petitioners' opening net worth as well as the increases in their net worth over the period in question. Respondent must, however, also establish either that a likely source of unreported income existed or negate the existence of all nontaxable sources of income.

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[19] See Kattar v. Commissioner, T.C. Memo. 1984-387.

We believe that respondent has conclusively negated all possible nontaxable sources of income by verifying all of petitioners' claimed inheritances, loans from children, and cash on hand. Indeed, the instant case is a somewhat anomalous net worth case because petitioners were attributed with $63,806.40 in cash on hand for purposes of the opening net worth. This amount was diminished to $13,806.40 by the close of the computation period, thereby providing petitioners with the use of $50,000, which presumably had been accumulated during prior years. Respondent also gave the Cardullas credit for loans that Mr. Cardulla's business received from Richard J. Cardulla and JoAnne Heck. Respondent also verified that petitioners did not receive any inheritance from the estate of Mrs. Cardulla's mother until 1976. The record clearly indicates that the Commissioner conducted a thorough investigation of leads enabling him to accurately negate the existence of all nontaxable sources of income. All of the information given to respondent by petitioners was painstakingly corroborated through third party interviews and through the detailed documentation compiled by respondent during the course of his investigation.

The parties have stipulated that during the taxable years in question, petitioners derived taxable income from sources which included (a) fees from the Lehigh Valley Railroad and the Erie Lackawanna Railroad to clean their tracks following train derailments, and (b) receipts from the resale of those items salvaged during the clean up of these train derailments. The

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grossly deficient records maintained by petitioners could not be used by respondent to verify the extent to which the receipts from these sources were not reported as income. We believe, however, that the record creates a very strong inference that the gross receipts from Mr. Cardulla's salvage and sales operations represented the primary source of petitioners' unreported income. Thus, although not required to do so, we find that, in addition to negating all possible sources of nontaxable income, respondent has established the likely source of petitioners' unreported income for the period in question. We, therefore, conclude that the Holland standards have been complied with in the instant case, and that the Commissioner's net worth analysis constitutes a sufficient basis on which to sustain his burden of proving, by clear and convincing evidence, the existence of an underpayment for each of the years in issue.

We must next determine whether such underpayment of tax for each year was due to fraud within the meaning of section 6653(b). To establish fraud, the Commissioner must show that the taxpayer intended to evade taxes which he knew or believed were owing, by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Webb v. Commissioner, 394 F.2d 366, 377-378 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Powell v. Granquist, 252 F.2d 56, 60 (9th Cir. 1958); Acker v. Commissioner, 26 T.C. 107, 111-112 (1956).

The presence or absence of fraud is a factual question that must be determined by examining the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). However, because direct proof of the taxpayer's intent is rarely available, fraud may be proven by circumstantial evidence. Spies v. United States, 317 U.S. 492 (1943); Gajewski v. Commissioner, supra at 200; Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, 53 T.C. at 105-106.

The evidence in the instant case convincingly establishes that Mr. Cardulla fraudulently underpaid his taxes during each of the years in issue.[20] Petitioners failed to maintain books and records during the taxable years in issue. Taxpayers are under a duty to keep adequate books and records. Section 6001; section 1.6001-1, Income Tax Regs. Although respondent was successful in obtaining copies of Mr. Cardulla's bank records, such records are an entirely inadequate means of recording petitioners' actual income, sales, and expenses. Mr. Cardulla's failure to maintain books and records in and of itself constitutes a significant indicia of fraud. Harper v. Commissioner, 54 T.C. 1121, 1141 (1970); Otsuki v. Commissioner, supra at 111.

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[20] Respondent concedes that petitioner Mary Cardulla is not liable for the sec. 6653(b) addition to tax for petitioners' 1973, 1974, and 1975 taxable years.

Petitioners claim that their failure to maintain adequate books and records was due to a lack of knowledge on their part. This assertion, however, is strongly controverted by the facts in evidence. Mr. Cardulla successfully operated a business which afforded his family with a substantial income. In addition, he was able to verbally provide his accountant with enough information to construct a financial statement for Home Savings and Loan. This financial statement accurately set forth, in detail, petitioners' net worth as of that time and, in fact, is very similar to the net worth statement prepared by respondent for the instant case. The decedent's business expertise and his understanding of the value of his assets clearly demonstrate that he was well informed and was quite capable of keeping adequate books and records from which the Cardullas' true income could have been readily ascertained.

Additional evidence of fraud is found in the Cardullas' failure to report $37,000 in business receipts received by Mr. Cardulla from the sale of meat to a store owner in Binghamton, New York in 1974. In addition, Mr. Cardulla told respondent's investigators during a 1976 interview that it was his practice to deposit all business receipts into his business checking account. When asked about a certain $12,946.79 amount deposited into petitioners' personal savings account on November 9, 1974, however, Mr. Cardulla indicated that although the money came from the sale of merchandise, it did not constitute taxable income because he was merely replacing funds that he had withdrawn from his personal savings account for business purposes. Mr. Cardulla admitted, however, that the personal funds that he had initially used to pay business expenses were claimed as deductions on his Federal income tax return. The decedent told respondent's investigators that the $12,946.79 was deposited into his personal savings account at Community Savings Bank because he wanted the funds to earn interest for him.

In total, petitioners failed to report $33,213.67 in 1973; $57,853.50 in 1974; and $48,542.23 in 1975 in taxable income.[21] A pattern of consistent and substantial underreporting of income for a number of years is further indicia of Mr. Cardulla's fraudulent intent to evade taxes, particularly when accompanied by other circumstances evidencing an intent to conceal. Holland v. United States, 348 U.S. at 139; Lollis v. Commissioner, 595 F.2d 1189, 1191 (9th Cir. 1979), affg. a Memorandum Opinion of this Court; Furnish v. Commissioner, 262 F.2d 727, 729 (9th Cir. 1958); Baumgardner v. Commissioner, 251 F.2d 311, 322 (9th Cir. 1957); Kurnick v. Commissioner, 232 F.2d 678, 681 (6th Cir. 1956). We note that the understatement in the instant case is in excess of three times that which petitioners reported as taxable income during the years in issue.

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[21] We note that these figures were taken directly from respondent's net worth calculations and will have to be adjusted to account for the exclusion of those custodial bank accounts held in trust by petitioners for their grandchildren and the depreciation allowance relating to the Cardullas' Mercedes Benz.

During the taxable years in issue, the Cardullas maintained 28 bank accounts, some of which were held in the names of various family members. In 1975, the decedent and Mrs. Cardulla deposited $14,001.02 into bank accounts held by them in custodial accounts. Thus, the Cardullas deposited more than one-third of their unreported income in taxable year 1975 into these accounts, and close to twice the amount of taxable income reported by the Cardullas on their income tax return. This gross disparity of reporting only $8,865 on their 1975 return, while depositing $14,001.02 into various trust accounts, indicates that Mr. Cardulla was aware that his income was substantially greater than that which he was reporting, and that these deposits were an attempt to conceal his unreported income. Such concealment is clearly indicative of fraud.[22] In addition, the Cardullas purchased a Mercedes Benz in 1975 at a cost of $9,800, put a $22,000 down payment on a home in 1975, and purchased a New York City Bond in 1973 at a cost of approximately $10,000. These major expenditures contrast sharply with the amount of taxable income reported by the Cardullas for the years in question and suggest an awareness on the part of decedent that he and his wife's income was much greater than that which they reported.

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[22] Estate of Steinberg v. Commissioner, T.C. Memo. 1965-244, affd. 367 F.2d 130 (2d Cir. 1966).

During the course of the Government's investigation, the decedent made several misleading or false statements to respondent's agents. In 1974, Mr. Cardulla received $37,000 from the sale of meat to a store owner in Binghamton, New York. Mr. Cardulla told respondent's investigators that he deposited the $37,000 amount into his Marine Midland business checking account with a notation on the deposit slip that the amount constituted a loan. Mr. Cardulla also told his accountant that the $37,000 represented a loan and, accordingly, the amount was not included by the accountant on the Cardullas' 1974 Federal income tax return. During respondent's subsequent investigation, however, the decedent told Special Agent Randy Vaughn that if the $37,000 was not reported on his return it was due to his accountant's error.

During a May 3, 1976 interview, Mr. Cardulla stated that the only assets that he owned consisted of his 1970 automobile, some NEL funds, two pieces of property in Victor, New York, and a paid-up life insurance policy. Respondent's investigators subsequently determined, however, that at the time Mr. Cardulla made this statement he also owned property in Florida, a Mercedes Benz, and both a ranch and an apartment building in California. Such false and misleading statements constitute further evidence of the decedent's fraudulent intent. Estate of Mazzoni v. Commissioner, 451 F.2d 197, 202 (3d Cir. 1971); Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980); Sunbrock v. Commissioner, 48 T.C. 55, 66 (1967).

Petitioners made several arguments in support of their contention that respondent has failed to meet his burden of proving that the underpayment of tax for the 1973, 1974, and 1975 taxable years was due to fraud. Petitioners allege that because the inconsistent statements made by Mr. Cardulla were made to respondent's agents during the investigation instead of at the time of the filing of the tax returns for the years in issue, they may not be used to infer decedent's fraudulent intent. While it is true that respondent must show that Mr. Cardulla intended to evade his tax liability at the time he filed his returns, respondent has not relied solely on Mr. Cardulla's inconsistent statements to establish fraudulent intent. Rather, respondent has conclusively proven that the decedent possessed the requisite knowledge at the time he filed his tax returns to know that he was underreporting his taxable income by substantial amounts. Indeed, Mr. Cardulla understated his income by more than three times the amount reported. These substantial understatements occurred during years when he and Mrs. Cardulla made substantial deposits to their 28 bank accounts, purchased a 26 acre ranch, an eight unit apartment building, a $10,000 New York City Bond, and a Mercedes Benz automobile.

Petitioners assert that because respondent has failed to show that petitioners' underreported their interest income from their various bank accounts, no fraudulent intent can be found. As respondent points out, however, and we agree, the net worth method of reconstructing income does not allege specific underreporting such as interest from a particular savings account. Instead, the net worth method proceeds on the premise that if the increase in a taxpayer's net worth during a particular year, plus all nondeductible expenditures during that year exceed reported net income for the year, the excess constitutes unreported income. Holland v. United States, 348 U.S. 121 (1954). Thus, respondent's assertion of the addition to tax for fraud was not in any specific way premised on petitioners' failure to report interest income.

Petitioners also argue that their failure to claim a deduction for the depreciation and expenses associated with their apartment complex in California implies that the Cardullas' failure to report the rental income from this property or to admit to respondent that they actually owned the building was not due to fraud. We disagree. The fact that the "losses" from this property exceeded the income produced over the same period is not determinative. Mr. Cardulla's failure to report the deductions associated with this property is in and of itself an indicia of fraud because it effectively veiled not only the additional income from the rental receipts produced by the property, but also the fact that petitioners' salvage business was generating sufficient income to allow the Cardullas to purchase an eight unit apartment building. This is especially true in light of the fact that Mr. Cardulla failed to inform his accountant, who actually prepared petitioners' tax returns during the period in issue, that he had purchased this income producing property.

Petitioners next allege that the decedent's training and education was so minimal and his schedule so busy, that he could not have intended to evade his tax liabilities. The evidence, however, paints quite a different picture. If all of Mr. Cardulla's business receipts were deposited into his business checking account, his accountant would have been able to easily and correctly calculate petitioners' taxable income. This simple procedure certainly would not have interfered with Mr. Cardulla's busy schedule. Furthermore, petitioner was able to find the time to invest in new rental property, fill out financial statements, and purchase a municipal bond during the same period that he was "too busy" to properly account for his income. For the reasons that follow, we do not believe that petitioners' "busyness" should preclude us from finding fraud in the instant case.[23]

The facts conclusively show that the decedent, despite his limited formal education, was an intelligent and resourceful individual. Indeed, he successfully operated two different types of businesses, first a turkey farm, and later a railroad salvage business. He was canny enough to advise his accountant that certain receipts from his business constituted a loan so that the amount would not be reported as taxable income. He purchased real estate in three different states and invested his money in a variety of stocks and bonds. Furthermore, Mr. Cardulla was able to provide his accountant with enough information to develop a financial statement for a savings and loan institution. Mr. Cardulla's ability to successfully manage both his vocation and his investments indicate that he fully understood his business and financial circumstances. The absence of a formal education is often due to diminished opportunity rather than a lack of intelligence. Mr. Cardulla was an astute and enterprising individual who applied his abilities successfully. We believe that he was fully aware that the amounts reported on his Federal income tax returns did not truly reflect the income he was generating during the years in issue.

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[23] See Leeby v. Commissioner, T.C Memo. 1956-118.

In Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), the taxpayer argued that because his limited formal education did not extend beyond the fifth grade, his understatements were due to ignorance rather than fraud. The court rejected this argument.

> We assume that common sense can be the possession of the unsophisticated, the unschooled, and the unlettered. [Petitioner], though not privileged to have the other ingredients, was in possession of common sense. He must have, by the exercise of common sense, known that the figures used in his tax return were serious understatements of his obligations to his government. Innocent falsity is generally improbable; here it is impossible. [Webb v. Commissioner, supra at 380. Emphasis added.][24]

Petitioners next assert that respondent failed to produce sufficient evidence to support his claim that in 1974 the decedent received $37,000 in business receipts which he failed to report. We disagree. Mr. Cardulla alleges that he failed to report the $37,000 as taxable income because the money was used to repay certain amounts previously taken from his personal savings and loaned to the decedent's business prior to January 1973. Petitioners contend that the $37,000 was a de facto return of capital and, therefore, was nontaxable. Petitioners, however, have not provided this Court with any evidence to support this assertion. Indeed, respondent's investigator testified that the expenses associated with the $37,000 business receipt had previously been deducted by petitioners. Furthermore, although petitioners note on brief several occasions on which Mr. Cardulla claims to have transferred money from his personal savings accounts to pay business expenses, there is nothing to indicate that he did not also deduct these business expenses as they were incurred.[25]

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[24] See also Bahoric v. Commissioner, 363 F.2d 151 (9th Cir. 1966); Nadell v. Commissioner, T.C. Memo. 1974-227; Bollella v. Commissioner, T.C. Memo. 1965-162, affd. 374 F.2d 96 (6th Cir. 1967); Estate of Bernstein v. Commissioner, T.C. Memo. 1956-260, affd. 267 F.2d 879 (5th Cir. 1959).

Based on the record as a whole, it is clear that petitioners' underpayment of tax for each of the years in issue was attributable to Mr. Cardulla's fraudulent intent to evade tax. We will, therefore, sustain respondent's imposition of the addition to tax for fraud as to Mr. Cardulla for all of the years in issue.

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[25] Petitioners also asserted that Revenue Agent Zingaro in some way fabricated evidence. We find this claim to be malicious and wholly without merit. In addition, we find no merit in petitioners' allegation that respondent's investigators failed to fully record the various interviews with petitioners and other persons. Indeed, Revenue Agent Zingaro recorded these interviews in their entirety and copies of Mr. Zingaro's notes were subsequently placed into evidence at petitioners' own request. Finally, we find utterly absurd petitioners' contention that respondent in some manner orchestrated the absence of the Cardullas' accountant from the trial of the instant case.

Statute of Limitations

Section 6501(c)(1) provides that "[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed * * * at any time." Thus, our determination that the Cardullas' joint income tax returns for their 1973, 1974 and 1975 taxable years were fraudulent negates petitioners' assertion that the statute of limitations bars assessment of the deficiencies and additions to tax herein.

Innocent Spouse Provisions

We deal next with whether Mrs. Cardulla qualifies for relief from liability under the innocent spouse provision found in section 6013(e). According to respondent, section 6013(e) is not applicable to relieve Mrs. Cardulla of joint and several liability for the deficiencies and the interest resulting from petitioners' underreporting of taxable income.[26]

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[26] Sec. 6013(e), as amended by the Deficit Reduction Act of 1984, Pub. L. 98-369, sec. 424(a), 98 Stat. 494, 801, provides in pertinent part, as follows:

> (e) SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.--
> (1) IN GENERAL.--Under regulations prescribed by the Secretary, if--
> (A) a joint return has been made under this section for a taxable year,
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,
> (C) the other spouse establishes that in

(footnote continued)

Petitioners have the burden of proving that all four of the statutory prerequisites for relief pursuant to section 6013(e) have been satisfied. Rule 142(a); Ratana v. Commissioner, 662 F.2d 220, 224 (4th Cir. 1981), affg. in part and revg. in part a Memorandum Opinion of this Court; Sonnenborn v. Commissioner, 57 T.C. 373, 380-381 (1971). The first requirement of section 6013(e) is that a joint return must be made for each of the taxable years in issue. Section 6013(e)(1)(A). In the instant

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> signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
>
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.
>
> (2) GROSSLY ERRONEOUS ITEMS.--For purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse--
>
> (A) any item of gross income attributable to such spouse which is omitted from gross income, and
>
> (B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.
>
> (3) SUBSTANTIAL UNDERSTATEMENT.--For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6661(b)(2)(A)) which exceeds $500.

The amendments in sec. 6013(e) found in the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494 were made applicable to all cases pending at the time of their enactment.

case, the parties both agree that petitioners filed joint Federal income tax returns in all three of the years in question. Respondent contends, however, that petitioners have failed to satisfy the remaining requirements of section 6013(e).

In order to be relieved of liability, there must be a "substantial understatement of tax attributable to grossly erroneous items of one spouse." Section 6013(e)(1)(B).[27] Section 6013(e)(2) defines the term "grossly erroneous items" to mean, with respect to any spouse "any item of gross income attributable to such spouse which is omitted from gross income." Based on the record as a whole, we are satisfied that Mr. Cardulla had exclusive control over Cardulla Sales, which was the primary source of the unreported income in the instant case. Accordingly, we conclude that because the income omitted from the Cardullas' tax returns was attributable to the decedent and because we find that the omitted amount constitutes a "substantial understatement," petitioners have satisfied the requirements of section 6013(e)(1)(B).

Petitioners must next satisfy the third element of section 6013(e) which requires that the spouse seeking relief under this provision establish that "in signing the return he or she did not know, and had no reason to know, that there was such substantial

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[27] A "substantial understatement" is defined in sec. 6013(e)(3) as any "understatement" which exceeds $500. Sec. 6661(b)(2)(A) defines an "understatement" as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of tax imposed which is actually shown on the return.

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understatement." Section 6013(e)(1)(C). Although Mrs. Cardulla worked in the retail store for Cardulla Sales during the years in issue, we do not believe that she had any actual knowledge of these substantial underpayments. We note that such knowledge may be imputed if a person possessing Mrs. Cardulla's experience and temperament would have known of the omissions. In order for petitioners to satisfy Mrs. Cardulla's burden of proof with respect to whether she had reason to know of the omitted income, the Cardullas "must establish that a reasonably prudent taxpayer, with her knowledge of the family finances, would have no reason to know of the omission." Estate of Jackson v. Commissioner, 72 T.C. 356, 361 (1979). For the reasons stated below, we do not believe that Mrs. Cardulla had reason to know that there was a substantial understatement for each of the years in issue.

In determining whether a spouse had reason to know of an understatement, this Court views as significant that spouse's degree of participation in business affairs or bookkeeping. Quinn v. Commissioner, 62 T.C. 223 (1974), affd. 524 F.2d 617 (7th Cir. 1975). Mrs. Cardulla testified that Mr. Cardulla did not involve her in his business affairs.

Respondent asserts that because Mrs. Cardulla was effectively responsible for the day-to-day operation of the Cardulla Sales retail store, she would a fortiori have been aware that their income had been understated for each of the years in issue. We disagree. Although Mrs. Cardulla sold merchandise in the Cardulla Sales retail store, we do not believe that her very limited involvement (e.g., sales clerk) in her husband's business made her at all aware that Mr. Cardulla was underreporting their income during the years in issue. We also note that Mrs. Cardulla did not participate in any way in her husband's bookkeeping. Furthermore, Mrs. Cardulla's standard of living during this period did not increase in such a way that she would have been effectively on notice that the income earned by her husband was greatly in excess of that which the decedent reported on their Federal income tax returns. Additionally, none of Mr. Cardulla's expenditures during the period in question were sufficiently lavish such that they would have caused Mrs. Cardulla to be aware of these understatements. Mysse v. Commissioner, 57 T.C. 680, 697-699 (1972).

Mrs. Cardulla totally relied on her husband to handle the family finances. Mrs. Cardulla had no accounting or bookkeeping experience and she logically, although mistakenly, presumed that her husband had properly completed their income tax returns. We found Mrs. Cardulla to be a candid and honest witness and we believed her testimony on this issue. Accordingly, we conclude from our examination of the evidence presented that the facts available to Mrs. Cardulla by virtue of her perfunctory participation in her husband's business are insufficient to provide the "reasonably prudent taxpayer" with reason to know of the omitted income. See Sanders v. United States, 509 F.2d 162, 167-170 (5th Cir. 1975); cf. Adams v. Commissioner, 60 T.C. 300, 303 (1973). Compare Sonnenborn v. Commissioner, 57 T.C. at 382.

Having determined that Mrs. Cardulla neither knew nor reasonably should have known of the substantial understatements of tax for the taxable years at issue, we must next determine whether, taking all of the facts into consideration, "it is inequitable to hold [Mrs. Cardulla] liable for the deficiency in tax for such taxable year." Section 6013(e)(1)(D). Although no longer a specific requirement of section 6013(e)(1), whether Mrs. Cardulla benefited from the substantial understatements of income is a factor to be considered in making this determination. See H. Rept. 98-432 (Part 2) 1501, 1502 (March 5, 1984).[28]

We conclude, for the reasons that follow, that it would be inequitable to impose liability upon Mrs. Cardulla. The term "inequitable" is defined under section 1.6013-5(b), Income Tax Regs., as follows:[29]

> Whether it is inequitable to hold a person liable for the deficiency in tax * * * is to be determined on the basis of all the facts and circumstances. In making such a determination a factor to be considered is whether the person seeking relief significantly benefited, directly or indirectly, from the items omitted from gross income. However, normal support is not a significant "benefit" for purposes of this determination. * * * [Emphasis added.]

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[28] Prior to its 1984 amendment, sec. 6013(e)(1)(C) specifically required that we make our determination as to whether it is inequitable to hold the "innocent spouse" liable for the deficiency by "taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income."

[29] We note that sec. 1.6013-5(b), Income Tax Regs., was promulgated prior to the effective date of sec. 424(a) of the Deficit Reduction Act of 1984, Pub. L. 98-369 98 Stat. 494, which removed the specific reference to a significant benefits determination.

Respondent contends that Mrs. Cardulla received significant benefits from the income omitted from the Cardullas' 1973, 1974, and 1975 tax returns. We disagree. Although some of petitioners' bank accounts were in Mrs. Cardulla's name, and certain other assets, including the New York City bond, the California ranch and the apartment building were held jointly by she and her husband, we do not believe that Mrs. Cardulla significantly benefited from her ownership interest in these assets. Indeed, we believe that the benefits received by Mrs. Cardulla as a result of the unreported income were in the nature of ordinary family support, which is not a sufficient basis to support a finding of significant benefit. Terzian v. Commissioner, 72 T.C. 1164, 1172, 1173 (1979); Mysse v. Commissioner, supra at 698, 699.

The testimony given in the instant case by Mrs. Cardulla and others paints a rather austere picture of Mrs. Cardulla's life as an uneducated, hard working person who spent seven days a week laboring in her husband's retail store. Furthermore, the recent amendments in section 6013(e) dictate that a more liberal interpretation be given to the innocent spouse provisions. See H. Rept. 98-432 (Part 2) supra at 1503. In light of these statutory changes, we do not believe that the incidental benefits enjoyed by Mrs. Cardulla are sufficient to make it equitable to impose liability in the instant case. We, therefore, conclude that Mrs. Cardulla has sustained her burden of proving herself entitled to the benefits afforded to an innocent spouse pursuant to section 6013(e).

To reflect the foregoing,

Decision will be entered
under Rule 155.

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UNITED STATES TAX COURT

SAMUEL E. HUNTER AND JOAN C. HUNTER, Petitioners *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10256-83. Filed July 23, 1986.

Martin S. Ackerman, *Stuart M. Bernstein* and *Benjamin Aerenson*, for the petitioners.

David M. Brandes, *Barry Guberman* and *Diane Matulla*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, *Judge*: In the statutory notice of deficiency, respondent determined a deficiency in petitioners' 1979 Federal income tax in the amount of $13,329.[1] In his amended answer to

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[1] Petitioners conceded errors on their 1979 Federal income tax return. The parties stipulated that had respondent been aware of (footnote continued)

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the petition, respondent claimed a $4,949 increased deficiency (for a total deficiency of $18,278) and an addition to the tax under section 6653(a)[2] in the amount of $914. Further, respondent claims additional interest under section 6621(d), asserting that petitioners substantially underpaid their 1979 tax and that such underpayment was attributable to a tax motivated transaction.

The issues for decision are: (1) the amount, if any, of the deduction to which petitioners are entitled for contributions of limited edition prints to various charitable institutions; (2) whether petitioners are liable for the addition to tax under section 6653(a); and (3) whether petitioners are liable for additional interest under section 6621(d).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Samuel E. Hunter and Joan C. Hunter, husband and wife, resided in New York, New York, at the time the petition herein was filed. During 1978 and 1979, Mr. Hunter was a vice

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those errors, respondent's notice of deficiency would have reflected a 1979 tax deficiency in the amount of $14,282, rather than $13,329.

[2] All statutory references are to the Internal Revenue Code of 1954, as amended and in effect in 1979, and all Rule references are to the Tax Court Rules of Practice and Procedure.

president of the investment firm of Merrill Lynch Pierce Fenner & Smith; Mrs. Hunter was not employed. The amount of Mr. Hunter's 1979 income was substantial, and he was interested in sheltering that income from taxation.

A friend of Mr. Hunter informed him of a program promoted by Martin Ackerman which involved the purchase and subsequent donation of works of art to museums. In early October, 1978, petitioners, together with others, met Mr. and Mrs. Ackerman at a breakfast meeting at the Ackermans' home. At the meeting, Mr. Ackerman discussed the tax benefits which could be derived by purchasing limited edition prints[3] for amounts less than their retail list prices and subsequently donating the prints to charitable institutions. Mr. Ackerman stated that Sovereign American Art Corporation (Sovereign), of which he was the president and of which his wife was the controlling shareholder, and its subsidiary, Rocquencourt, A. G., a Lichtenstein corporation (Rocquencourt), had purchased a quantity of signed, limited edition prints at prices substantially less than their listed retail prices. Mr. Ackerman stated that these prints could be purchased from Rocquencourt for approximately one-third of their retail list prices and that if the purchasers thereafter contributed the prints to charitable institutions,[4] the contributors could obtain a tax deduction equal to approximately three times the purchase price.

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[3] A limited edition print is one of a finite, predetermined number of identical copies of an image, reproduced on paper. An edition may also be comprised of sets of prints, which may be sold as sets, or, in some cases, as single prints.

Petitioners told Mr. Ackerman that they were willing to spend a maximum of $10,000 on prints. They then accompanied Mr. Ackerman to the warehouse where the prints for sale were stored. The prints were spread out on tables, and petitioners selected the following prints for purchase:

1. Herbert Bayer - 3 sets of 3 prints;
2. Sidney Nolan - 3 sets of 23 prints; each set consisted of a series of 14 different single prints, plus one work which alone consisted of 9 prints;
3. Lee Krasner - 3 sets of 3 prints;
4. Seymour Lipton - 3 sets of 3 prints;
5. Conrad Marca-Relli - 2 sets of 6 collage prints, "Autumn Suite";
6. Beverly Pepper - 3 sets of 8 collage prints;
7. Larry Rivers - "Boston Massacre";
8. Patrick Caulfield - "Jules LaForge"; and
9. Elizabeth Frink - "Aesop's Fables".

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[4] Petitioners were advised that the Martin S. Ackerman Foundation would assist in facilitating the contribution of the prints to qualified institutions. For this assistance, it was expected that petitioners would make a modest cash donation to the Foundation.

Petitioners obtained the prints with the intention of donating some of them to charitable organizations and retaining some of them for their personal enjoyment. The prints purchased by petitioners had been acquired by Sovereign from Marlborough Gallery, Inc. (Marlborough) in August, 1978 at prices approximating Marlborough's cost,[5] i.e., one-sixth Marlborough's retail list prices. Sovereign then transferred ownership of the prints to Rocquencourt for resale to third parties[6].

Except for the prints by Sidney Nolan (which were selected on the basis of samples and at the time were located in England), all the prints selected were placed in a separate drawer with petitioners' name on it. Petitioners never had physical possession of the prints. The prints were insured by Sovereign under its bulk policy as goods sold but not delivered.

Petitioners received an invoice from Rocquencourt for the prints, dated October 10, 1978, in the amount of $9,278. Petitioners paid $2,200 by check dated October 23, 1978, and gave a note for the balance. The note bore interest and was paid in March, 1979.

All of the art purchased by petitioners, except for the works by Rivers, Caulfield and Frink, were donated at various dates in December, 1979 to various charitable institutions. The cost of shipping the prints to the institutions was paid by Sovereign, but the contributions were made in petitioners' names. Each donee institution sent petitioners a written acknowledgement with respect to the donated prints.

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[5] Marlborough was the publisher and original distributor of most of the editions purchased.

[6] The purpose of using Rocquencourt to effect sales to third parties was to avoid the New York sales tax.

The prints sold to Sovereign (and subsequently resold to petitioners) were "old" in that they had been held for sale by Marlborough for at least four years after their publication and constituted excess inventory in the hands of Marlborough. The prints donated by petitioners in 1979 had initially been published by Marlborough as follows:

Bayer	1969-1973
Nolan	1965-1972
Krasner	1969
Lipton	1969
Marca-Relli	1974
Pepper	1968

Most retail sales for a print edition take place within the first 2-3 years after publication.

During the fall of 1978, Sovereign and Rocquencourt sold multiples of prints from the same editions by Bayer, Nolan, Krasner, Lipton, Marca-Relli and Pepper to 42 different purchasers, including the Hunters. Sovereign sold to 22 buyers and Rocquencourt sold to 20 buyers. In 1979, 38 of the 42 purchasers donated some of the prints purchased from Sovereign or Rocquencourt to charitable institutions,[7] and each of the 38 purchasers (including the Hunters) contributed $100 to the Foundation.

Petitioners' cost for the prints in 1978, and the claimed fair market value of the prints when donated to the institutions in 1979, are as follows:

	Cost	Claimed Fair Market Value
Bayer	$ 788.68	$ 3,150.00
Nolan	3,395.96	13,500.00
Krasner	510.32	2,025.00
Lipton	343.31	1,350.00
Marca-Relli	1,512.41	6,000.00
Pepper	909.30	3,600.00
	$7,459.98	$29,625.00

In their 1979 tax return, petitioners claimed a charitable contribution deduction in the amount of $36,875. The amount of the claimed deduction was based on a written appraisal for the prints, signed by Max Wykes-Joyce.[8] Mr. Ackerman had arranged for the appraisals, and the fee for the appraisal was paid for by Sovereign. At the time they filed their return, petitioners mistakenly believed that they had contributed the works by Rivers, Caulfield and Frink. Their mistake was due to the fact that a list of donated prints prepared by Mr. Ackerman, upon which petitioners relied in preparing their return, erroneously included prints by these three artists. Petitioners have since conceded that the works by Rivers, Caulfield and Frink were not in fact donated; their claimed contribution deduction is now $29,625.

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[7] Approximately 90% of the Bayer prints, 50% of the Nolan prints, 85% of the Krasner prints, 85% of the Lipton prints, 60% of the Marca-Relli prints, and 80% of the Pepper prints which Sovereign or Rocquencourt sold in 1978 were donated to charitable institutions in 1979.

Respondent contends that petitioners are not entitled to any charitable contribution deduction because petitioners never owned the prints they purported to donate. Rather, claims respondent, petitioners entered into a transaction with Mr. Ackerman solely to obtain tax benefits. Respondent claims the purported purchase and subsequent donations of the prints were devoid of economic substance and thus were sham transactions which cannot give rise to a charitable contribution deduction.

Respondent argues in the alternative that if petitioners are entitled to a charitable contribution deduction, the amount of the deduction is less than that claimed because (1) petitioners did not satisfy the long-term holding requirement of section

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[8] Each appraisal was signed by Mr. Wykes-Joyce, but was actually prepared by several people, including Mr. Ackerman. Mr. Wykes-Joyce did not testify at trial.

170(e)(1)(A); (2) petitioners' activities were substantially equivalent to those of commercial art dealers; thus, the sale of the prints would have produced ordinary income and a reduction in the amount of the contribution is required under section 170(e)(1)(A); and (3) the fair market value of the prints at the time of contribution was not greater than the amount petitioners paid for them.

Respondent also seeks an addition to the tax pursuant to section 6653(a) and an increased rate of interest pursuant to section 6621(d).

ULTIMATE FINDINGS OF FACT

(1) Petitioners owned the prints at the time (December, 1979) the prints were donated to various qualified institutions.

(2) The fair market value of the prints contributed by petitioners in 1979 was $7,460.

(3) Petitioners substantially underpaid their 1979 tax, which substantial underpayment was attributable to a tax motivated transaction, within the purview of section 6621(d).

OPINION

Section 170(a) allows as a deduction a contribution or gift to any entity described in section 170(c),[9] payment of which is made within the taxable year. Section 170A-1(c)(1), Income Tax

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[9] There is no dispute that the donation of the prints were made to entities described in section 170(c).

Regs., provides that the amount of a charitable contribution that is made in property other than money shall be the fair market value of the property at the time of contribution, reduced as provided in section 170(e)(1). Section 1.170A-(1)(c)(2), Income Tax Regs., defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." See United States v. Cartwright, 411 U.S. 546 (1973).

Respondent contends that petitioners never owned any prints, that the transactions were mere shams and that petitioners merely purchased a tax deduction which promised a three-to-one write-off on their investment. Respondent first raised this argument in his amended answer; it is new matter, and therefore respondent bears the burden of proof with respect to this issue. Rule 142(a). In support of his claim, respondent points out that there was no written transfer of title from Sovereign to petitioners, that Sovereign retained physical possession of the prints, that the prints were insured by Sovereign, that the packaging and shipment of the prints to the various donee institutions was done by Mr. Ackerman and that Mr. Ackerman (acting on behalf of his foundation) made the necessary arrangements by which the donee institutions would accept the prints.

In order to make a deductible charitable contribution, a putative donor must first own the property that he purports to transfer. The right to beneficial enjoyment of the property, rather than possession of the property, determines whether a taxpayer is recognized as the owner of property for Federal tax purposes. *Skripak v. Commissioner*, 84 T.C. 285, 316 (1985). A charitable contribution deduction is possible only after the gift has been delivered and only after the donor has parted with the dominion and control over the subject matter of the gift. *Guest v. Commissioner*, 77 T.C. 9 (1981); *Skripak v. Commissioner*, 84 T.C. at 318.

In our opinion, petitioners owned the prints at the time of donation. The lack of formal conveyance of title to petitioners prior thereto is not determinative;[10] title passed not later than October 23, 1978, the date on which petitioners received the invoice and made payment therefor by check and a note.[11]

As to respondent's contention that petitioners' tax-avoidance motive in making the contributions precludes allowance of the deductions, we shall repeat what we stated in *Skripak v. Commissioner*, 84 T.C. at 319:

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[10] N.Y.U.C.C. § 2-401(3) (McKinney 1979).

[11] Since petitioners owned the prints not later than October 23, 1978, and since the prints were donated to various charitable institutions in December, 1979, it is apparent that petitioners satisfied the long-term holding requirement of section 170(e)(1)(A).

> [R]espondent's seeming obsession with the mechanics of these transactions as shams appears to be caused by the admitted tax-avoidance motivation of the various petitioners. However, as stated above, the deduction for charitable contributions was intended to provide a tax incentive for taxpayers to support charities. Consequently, a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution. [Citations omitted.]

Thus, we hold petitioners are entitled to a charitable contribution deduction for the donation of the prints. We must now determine the amount of the charitable contribution deduction to which petitioners are entitled.

In determining the amount of the charitable contribution deduction to which petitioners are entitled, we must first determine whether the sale of the prints by petitioners would have produced ordinary income to them. Section 170(e)(1)(A) provides that the amount of any allowable charitable contribution shall be reduced by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value. Section 1.170A-4(b), Income Tax Regs., provides that "ordinary income property" includes property held by the donor primarily for sale to customers in the ordinary course of his trade or business. Respondent argues that petitioners' activities were substantially equivalent to those of a dealer in art works and that sale of the donated prints would therefore have produced ordinary income. We do not agree. As stated in our findings of fact, petitioners purchased the prints, in part, for the purpose of donating them to qualified institutions, and in part for personal enjoyment. Had the prints actually been sold, they would have produced long-term capital gain. Section 1221. In this sense, petitioners' purchase of the prints was no different from a purchase of stocks, stamps, gold, paintings, sculpture, or any of a number of other investment properties. In any event, we think that the limitation of section 170(e)(1)(A) does not apply in the absence of a finding that the donor actually engaged in the trade or business of selling works of art to customers. Petitioners, who never sold any work of art, are not transformed into dealers by virtue of their donations. See Anselmo v. Commissioner, 80 T.C. 872 (1983), affd. 757 F.2d 1208 (11th Cir. 1985). Petitioners are therefore entitled to a charitable contribution deduction equal to the fair market value of the donated prints at the time of the donation.

In determining the fair market value of the prints, we must examine the market in which the prints are ordinarily sold to the ultimate consumer. Lio v. Commissioner, 85 T.C. 56 (1985); Skripak v. Commissioner, 84 T.C. at 322; Anselmo v. Commissioner, supra; Goldman v. Commissioner, 388 F.2d 476 (6th Cir. 1967), affg. 46 T.C. 136 (1966). In Lio, we said, "the sale to the ultimate consumer is any sale to those persons who do not hold the item for subsequent resale * * * and the most appropriate market for valuation purposes is the most active marketplace for the particular item involved." Lio v. Commissioner, 85 T.C. at 70. Based on the large number of sales by Sovereign and Rocquencourt in the Fall of 1978, of the prints by Bayer, Nolan, Krasner, Lipton, Marca-Relli and Pepper, the six artists involved in this case, the most active marketplace in 1978 for the prints herein involved was that created by Mr. Ackerman.

Petitioners presented a plethora of evidence, including written appraisals of each artist's work and the testimony of three expert witnesses. Neither the appraisals nor the expert witnesses were persuasive. All experts failed to consider the price paid for the prints by petitioners.

The most probative evidence of the fair market value of the prints is the amount petitioners paid for them, especially as their acquisition occurred only one year prior to the time of contribution. Chiu v. Commissioner, 84 T.C. 722 (1985); Lio v. Commissioner, supra; Andrews v. Commissioner, 38 F.2d 55 (2d Cir. 1930), affg. 13 B.T.A. 651 (1928). Petitioners do not argue that any appreciation in value occurred from the date of acquisition to the date of contribution. Nor do we believe that any meaningful appreciation in value did occur. Hence, the fair market value of the prints on the date of contribution is the same as their fair market value on the date of acquisition by petitioners.

As was noted in Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1111 (6th Cir. 1984), revg. a Memorandum Opinion of this Court, "[I]n determining the fair market value of property, little evidence could be more probative than the direct sale of the property in question." Petitioners' explanation of the differential between the amount they paid for the prints and the prints' claimed fair market value is that Mr. Ackerman's close relationship with Marlborough enabled him to purchase the prints at a substantial discount from the retail price which he, in turn, passed on to petitioners. According to petitioners, Sovereign, through Mr. Ackerman, purchased the prints from Marlborough at approximately one-sixth of the retail price. Sovereign transferred the prints to Rocquencourt, who then sold the prints to petitioners at approximately one-third of the published retail value.

Sovereign, through Mr. Ackerman, was able to acquire the prints at a substantial discount from Marlborough's published retail price due to the fact that prints were old and constituted excess inventory in the hands of Marlborough. It is clear to us that the transaction between Rocquencourt and petitioners was at arm's length, involving as it did a 100 percent markup by Rocquencourt. The record is devoid of any explanation of why Rocquencourt would sell the prints to petitioners for less than fair market value. Neither Sovereign nor Rocquencourt purported to be a nonprofit organization. If Rocquencourt sold the prints for approximately one-third of what it might otherwise have obtained, as petitioners claim, then such from an economic point of view, makes no sense. As we found in Chiu v. Commissioner, supra, we also find here no credible explanation as to why petitioners would be able to acquire the prints at substantial discounts from value. Thus, we believe that the fair market value price of the prints in October, 1978 (as well as in December, 1979) was the price paid for them by petitioners.

Petitioners rely heavily on Marlborough's price list to establish fair market values for the prints. Marlborough's price list is relevant, but we are not persuaded that it is the only indicator of fair market value. List prices do not reflect actual sale prices, rather only asking price. Further, the prices on the list, according to petitioners' own expert, were sometimes kept artificially high, out of "honor and sympathy" for an artist whose work might not sell if it appeared that it was declining in value.

Petitioners submitted invoices which reflected actual sales by Marlborough and another gallery of single prints from the same editions at prices bearing some relationship to the published retail price. The gallery sales of single prints to dealers and non-dealers were incidental and do not reflect the prices commonly paid for these prints. Lio v. Commissioner, supra.

Multiples of prints from the same editions were sold by Sovereign and Rocquencourt during the fall of 1978 to at least 42 other buyers. Nothing in the record indicates that those sales were any different, in terms of price, from the "bargain" obtained by petitioners.

Respondent argues that the fair market values of the prints should be adjusted to reflect the fact that the value of the prints in the aggregate is less than the value of each individual print. If petitioners had placed all the prints on the market at the same time, claims respondent, the sudden availability of so many additional prints would have depressed the price of each print individually.

We have held that where the simultaneous marketing of a large number of items would necessarily depress the market for each item, fair market value should be determined by applying a blockage discount to the retail price of the items. *Jarre v. Commissioner*, 64 T.C. 183 (1975); *Estate of Smith v. Commissioner*, 57 T.C. 650 (1972), affd. on another issue, 510 F.2d 479 (2d Cir. 1975), cert. denied 423 U.S. 827 (1975). Where, however, the number of items to be valued is only an insigificant portion of the total number of such items, we have held that no blockage discount is appropriate. *Anselmo v. Commissioner*, *supra*.

We believe that a blockage discount is not warranted in this case. The number of prints purchased by petitioners represents only a small portion of the total number of prints within each edition, and an even smaller portion of the total work produced and outstanding by each artist. The marginal increase in supply which would have resulted from a sale by petitioners would not have seriously affected the prices of these prints.

Considering all the evidence, we come to the conclusion, and find as an ultimate finding of fact, that the fair market value of the prints at the time of contribution by petitioners in 1979 was $7,460.

Because respondent asserted an addition to the tax pursuant to section 6653(a) in its amended answer, respondent bears the burden of showing that petitioners' underpayment was the result of negligence or intentional disregard of rules or regulations. Rule 142(a). Based on the record before us, although petitioners' underpayment was due to their overvaluation of the prints, and their erroneous belief that they had contributed the prints by Rivers, Caulfield and Frink, respondent has not borne his burden of proof. Thus, we hold that petitioners are not liable for the addition to tax under section 6653(a).

We reach a different result with respect to respondent's claim that under section 6621(d) an increased rate of interest should apply. Section 6621(d) provides that interest which accrues after December 31, 1984 on a substantial underpayment attributable to a tax motivated transaction shall be 120 percent of the otherwise applicable rate.[12] Section 6621(d) applies only if a tax motivated transaction results in an underpayment in excess of $1,000. Section 6621(d)(2). A "tax motivated transaction" includes, among other things, any valuation overstatement, as defined in section 6659(c). Section 6659(c) defines a valuation overstatement as a claim on a return that the value of any property is 150 percent or more of the amount determined to be the correct value. Where multiple items of a similar nature are donated within the same taxable year, the aggregate value claimed by the taxpayer is compared to the aggregate value determined to be correct. Neely v. Commissioner, 85 T.C. 934 (1985). Here, petitioners' underpayment was attributable to a tax motivated transaction, i.e., a valuation overstatement within the meaning of section 6659(c), and the underpayment exceeds $1,000. Therefore, an increased rate of interest under section 6621(d) applies.

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[12] Respondent raised this issue by its pretrial motion dated January 23, 1985, a copy of which was served on petitioners. Although petitioners failed to address this issue on brief, they had adequate notice that we would consider the applicability of section 6621(d), and they presented at trial extensive evidence to support their valuation claim. See Johnson v. Commissioner, 85 T.C. 469 (1985), distinguishing Law v. Commissioner, 84 T.C. 985 (1985).

To reflect the foregoing, and to give effect to petitioners' concession,

Decision will be entered
under Rule 155.